

**E-COMMERCE:  
RELEVANCE OF SOURCE  
AND RESIDENCE RULES**

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## **ABSTRACT**

In the world of business, electronic commerce (“e-commerce”) is aggressively making its presence felt. E-commerce represents a whole new domain in which business transactions can occur, a whole new frontier to conquer and develop. It is a space, or to be more precise a “cyberspace”, that is radically distinct to the physical world in which the traditional business operate in. Such differences raise many issues, but the one canvassed here are about the relevance of source and residence rules within the framework of international taxation.

In applying existing source and residence rules to e-commerce transactions a substantial number of issues have arisen simply because the medium is so very different. Notwithstanding the large number of issues and the apparent difficulties in resolving some of these issues, this paper submits that the source and residence rules should continue to be relevant in determining taxing rights between different jurisdictions. These rules are fundamental to the operation of the widely accepted framework of international taxation.

This paper further submits that whilst a straight application of the well accepted source and residence rules to e-commerce transactions may pose difficulties, largely because those rules are developed for transactions of a different age; the underlying fact and circumstances approach, which is the foundation of these standardised rules in the first place, has the inherent flexibility to handle the new mode of transactions. The approach remains the same; but instead of relying on the standardised rule, there is a need to re-emphasise the role of the fact and circumstances approach, and in so doing new rules will evolve over time in respect of e-commerce. This is much more superior to a complete, or perhaps even a partial, reinvention of the international taxation framework.

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## **1.0 INTRODUCTION**

Electronic commerce (“e-commerce”) is almost unheard of a decade ago. It is now an area of intense growth in the business arena. Its speed of ascendance, its widespread impact and its very different nature have raise concerns as to whether current legal rules is capable of addressing issues that may arise from such mode of transactions. Taxation is an area that has been attracting significant attentions from national governments to large organisaitons, like the OECD<sup>1</sup> and International Fiscal Association<sup>2</sup>.

This paper explores the issues concerning the application of source and residence rules within the context of international income tax given the emergence of e-commerce.<sup>3</sup> In particular, the central question being addressed is whether source and residence rules are relevant to business transactions conducted through the internet. To this ends this paper is structured as follow:

- Section 2 outlines the broad features of e-commerce and the issues plaguing the application of source and residence rules;
- Section 3 provides an overview of current source and residence rules within the framework of international taxation;
- Section 4 explores the issues surrounding the application of the source and residence rules in e-commerce transactions.

It should be noted upfront that it is not the aim here to comment upon the appropriateness or merits of source-based and residence-based taxation. Such an inquiry exceeds the

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<sup>1</sup> The OECD held its first conference in Turku, Finland in November 1997. This is followed by the Ottawa Ministerial Conference in October 1998. The Technical Advisory Group (TAG) has been formed, resulting in the publication of various discussion papers and final recommendations in past few years. (See proceeding materials at <http://www.oecd.org/dsti/sti/it/ec/>) and the Paris OECD Forum on Electronic Commerce in October 1999 ([http://www.oecd.org/dsti/sti/it/ec/paris\\_ec/index.htm](http://www.oecd.org/dsti/sti/it/ec/paris_ec/index.htm)).

<sup>2</sup> The International Fiscal Association is also scheduled to have a conference in October 2001 to discuss e-commerce issue in the context of taxation.

<sup>3</sup> Note that consumption or indirect taxation in the context of e-commerce has also been attracting significant attention in recent years.

scope of this paper, as it would involve assessment of issues including tax efficiency, economic policies rationale, fairness, administrative issues, etc.

Just to clarify a few definitions used in this paper. ‘Traditional’ or ‘conventional transactions’ refers to sale or provision of service through predominantly physical means, such as mail order; but depending on the context, it may refer to the use of older form of communication technologies such as telephone or faxes. By contrast, ‘electronic transactions’ involve the use of network technologies such as the internet. For this purpose, internet can broadly be defined as a communication medium consisting of computer hardware and computer softwares that are interlinked by telecommunication infrastructures such as cables, satellite, servers, router, etc.

## **2.0 ELECTRONIC COMMERCE IN CONTEXT**

The term e-commerce is a broad notion that refers to commercial activities that is effected through various technological means, including things like facsimile, telex, electronic data interchange, internet, telephone.<sup>4</sup> The essence of e-commerce is the execution of commercial transactions- the sale of goods or services or some form of technology - through an electronic medium.<sup>5</sup> The transaction can involve individuals or corporations, wherever located, domestically or internationally. The subject matter of the transactions could be intangibles, data products or tangible goods.

Much statistic and evidence can be quoted in respect of the explosive growth of the internet as a communication medium and equally rapid rise in the number of e-commerce

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<sup>4</sup> Refer to paragraph 1.21 of the Report of the Electronic expert Group to the Attorney General (Australia), *Electronic Commerce: ‘Building the Legal Framework’*, (1998), available at: <<http://www.ag.gov.au/aghome/advisory/eceg/ecegreport.html>>.

The UK government’s *Electronic Commerce: The UK’s Taxation Agenda*, November 1999, paragraph 1.3 defined e-commerce as: “Using an electronic network to simplify and speed up all stages of the business process, from design and making to buying, selling and delivery e-commerce is the exchange of information across electronic networks, at any stage in the supply chain, whether within an organisation, between businesses, between businesses and consumers, or between the public and the private sectors, whether paid or unpaid.”

The IFA defines e-commerce as where “commercial transactions are placed electronically and the goods or services are delivered in tangible or electronic (digitised) form.”

<sup>5</sup> Davies, L. ‘Model For Internet Regulation’ (1998), available at <<http://www.scl.org/content/ecommerce>>.

businesses in recent years.<sup>6</sup> Despite such growth, “electronic commerce is still in an embryonic stage and the technologies and the market dynamics are still casting their basic shape.”<sup>7</sup> Yet it is clear that e-commerce will form a significant part of the economy of tomorrow. A broad range of transactions already used e-commerce now.<sup>8</sup>

To set the stage for subsequent discussion, a few key features of e-commerce are noted here.

### 2.1 An Electronic Medium

As noted above, the essence of e-commerce is that it emphasises electronic means of communication, or computer-to-computer transactions, using network technologies like the internet. One characteristic of this technology is that it is highly distributed and unstructured; the electronic signals that connect the end-user with, say, the vendor of online service, traverses through a series of different hubs, router, switch, with no pre-defined pathway.<sup>9</sup> In fact, on the internet, information are divided into different “packets”, and during transmission, these “packets” may and do travel through different paths.

Before the days of e-commerce, physical presence, physical delivery of goods and services are the norm. Under e-commerce, the word “physical” becomes optional. Physical presence is not needed; and where the goods or services are digitalised, neither is physical delivery.<sup>10</sup> Products such as software, video, books, music and even newspapers and magazines no longer have to be physically delivered in hard copy format

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<sup>6</sup> See description in Basu, S. ‘Taxation of Electronic Commerce’ (2001) *The Journal of Information, Law and Technology*, available at <<http://elj.warwick.ac.uk/jilt/01-2/basu1.html>>; Dickson, C. (2001), “Legal Issues For E-Business in Australia”, PricewaterhouseCoopers Legal, Unpublished paper.

<sup>7</sup> Dryden, J. ‘The Work of the OECD on Electronic commerce’, p. 2, available at <[http://www.oecd.org/subject/e\\_commerce/Ottawa\\_speech.pdf](http://www.oecd.org/subject/e_commerce/Ottawa_speech.pdf)>.

<sup>8</sup> For examples, wholesale and retail sales and leases of tangible goods; banking services, ticketing arrangement and brokerage transactions; software sale through website; sale of information by online service provider; advertising of products and professional services; stock trading; gambling. For further details refer to US Government Report ‘Selected Tax Policy Implication of Global Electronic commerce’ (1996), available at <<http://www.treas.gov/taxpolicy/internet.html>>.

<sup>9</sup> For detail description of the nature of this technology see CSIRO ‘Electronic Commerce Project’ (1997), available at <<http://www.ato.gov.au>>.

<sup>10</sup> Basu, S. (2001), *op. cit.*

to the purchaser. It is just as easy, if not more so, to deliver the same thing over the wire through the internet. Further, with computerisation and automation, even human intervention is made redundant from many transactions.

## **2.2 A New Sphere of Operation**

On a bigger scale, geographic boundaries cease to have meaning. Electronic transactions can flow seamlessly across jurisdictions. The increasing volume of transactions that transcend physical border have become a major concern to governments around the world because of the potential erosion of tax bases, as well as other enforcement issues.<sup>11</sup>

Cross-border transactions have always raised non-trivial issues. These issues used to arise in the fringes, and are relatively minor as compare with domestic tax issues. The problem is that with e-commerce, these relatively minor issues have suddenly been de-marginalised and took on a greater dominance as e-commerce is opening up a whole new world.<sup>12</sup> Internet commerce is expected to be five times larger than mail-order sales within five years.<sup>13</sup>

## **2.3 New Business Model**

Moving further into the future, if it is not already happening now, even the business process or model itself will change with the emergence of e-commerce.<sup>14</sup> Initially, e-commerce is simply an overlay on existing business; for example, in the case of selling goods online, the back office and distributions are handled by existing infrastructure. But increasingly, new ways of doing business, new way to derive income will emerge. E-commerce is already providing new means of making contracts and new methods of performance.

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<sup>11</sup> See, for example, Dickson, C. (2001), *op. cit.*

<sup>12</sup> Doernberg, R. and Hinnekens, L. *Electronic Commerce And International Taxation* (1999), Kluwer Law International, The Hague, Netherlands, p104.

<sup>13</sup> Basu, S. (2001), *op. cit.*

<sup>14</sup> Scott, D. "E-Commerce", 4<sup>th</sup> Annual Victorian State Convention, 30 August 2001, Taxation Institute of Australia.

This new electronic medium is definitely “accelerating the trend toward ‘virtual’ corporations with narrowly defined core competencies.”<sup>15</sup> With a narrow core competencies, these corporations tend to have a very small physical footprint. Aspects of carrying on a business that involve physical presence, such as manufacturing, distribution, fulfilment, customer service are outsourced to third parties. The electronic medium have greatly increased the ease with which companies can enter into joint ventures, partnerships, outsourcing agreements and other strategic relationships. And these relationships can change just as quickly. For example, eMachines<sup>16</sup> in the US is a personal computer reseller that sold 1.7 million computers globally in 1999, produced over US\$1 billion in revenue, and became the number 3 branded computer in the US. Yet, the company used only 20 employees to conduct its business, relying on other entities for virtually all of its operational functions.<sup>17</sup>

### **2.4 The Issues**

Over the years general consensus have been reached in relation to source and residence issues. With the growth of the internet, and the rise of e-commerce, and the different paradigm of transactions that it entails, the accepted rules dealing with such issues are once again put under pressure. Consider the source of income. As the physical location of an activity becomes less important, it becomes more difficult to determine where an activity has taken place; and hence, it becomes harder to determine the source of income. For example, what is the source of the sales income if the customer acquired the good by navigating through and clicking on a web site? Does it matter where the server powering this web site is located?

Further, the complexity can only increase with the diverse range of transactions possible under e-commerce. Electronic transactions cover a whole range of matters, from the traditional goods to the intangibles that in turn ranges from the provision of conventional services through to electronic ‘goods’ like data products or information. Further, the

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<sup>15</sup> Basu, S. (2001), *op. cit.*

<sup>16</sup> <http://www.emachines.com/>

<sup>17</sup> Further additional examples, refer to Basu, S. (2001), *op. cit.*

delivery could occur by conventional means, such as by post or courier, or it could be purely electronic such as the downloading of a piece of software

Residence becomes hard to determine. Dual residence, and indeed multiple residence, may arise. For instance, virtual corporation have more flexibility to relocate their assets or business compare to the traditional business. Changing the location of computer servers, key employees, or information technology personnel are relative easy compare to relocating a factory. Companies can more easily move to favourable tax regimes, or keep moving from one to another, never settling permanently in one place. The increasing use of 'intelligent' software agent on a web server, gathering information and presenting conclusions without the intervention of a human makes it much more difficult to ascertain where a business is conducted.<sup>18</sup> Likewise, knowledge workers and professional people are highly mobile.

It is in light of all these developments and unique features of e-commerce transactions that the source and residence rules are examined.

### **3.0 SOURCE AND RESIDENCE: THEIR PLACE IN THE INTERNATIONAL TAXATION FRAMEWORK**

Before embarking on a discussion about the relevance of source and residence in the context of e-commerce, it is worthwhile to be clear about how notions like source and residence fit into the overall international taxation framework.

This section proceeds by outlining the general framework of international taxation, and then moves on to summarise, in general terms, the operation of the source and residence rules that have been developed and accepted by various jurisdictions. In this regard, a distinction should be made between the notion of source-based taxation and residence-based taxation on the one hand, and source rules and residence rules on the other. The former are the twin pillar of international taxation framework; whereas the latter are the lower level, operational rules through which those principles are applied in practice.

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<sup>18</sup> Basu, S. (2001), *op. cit.*

### **3.1 Determining Taxing Rights**

Countries have struggled over the division of taxing rights for years. This is a fundamental struggle and is arguably the root of tax issues and tensions between jurisdictions. Fundamentally, the questions are: who should get tax? Whom should impose the tax? At which point should the transaction be taxed? The problem is a simple one: every jurisdiction want a *fair* share of the money generated in or through the world economy. Of course, how to determine the “fair” share is the issue in contention.

Historically, in the early days, countries adopt unilateral rules to deal with the relative few incidence of cross-broad transactions. Each jurisdictions can determine what is their “fair” share of the global money cake. As the volume of global transactions increase, unilateral actions became ineffective largely because of the rising incidence of double taxation; and hence, there are pressured for greater international cooperation. This led to the League of Nations convention, resulting in the establishment of a conceptual framework for allocating taxing rights in the international arena. This formed the basis of current international taxation practices.<sup>19</sup>

In general, for practical administrative and enforcement reasons a country only assert taxing authority over person or property that is sufficiently connected with it to enable it to impose authority over the person or property. Consequently, taxing rights depend primarily on the degree of connection with the jurisdictions. This makes sense because for Country X to assert the right to impose tax on the income derived by entity P, a logical requirement is that Country X should have some sort of relation or connection with entity P or the income derived by P.

#### **3.1.1 Source Based Taxation and Residence Based Taxation**

There are two broad approaches to identify this connection. Under the first approach, nexus is established with the income stream. That is, if the source of the income is regarded to be within the jurisdiction, the income is taxed by that jurisdiction. The focus

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<sup>19</sup> This is reflected in various models, for example, OECD Model Convention, UN Model, US Model, and Andean Model.

is on the economic connection that the particular item of income has to the taxing jurisdiction. For example, a country may impose a tax on business profits of a non-resident earned within that country. Investment income, including dividends, interest, royalties, and rent, may also be subject to tax in the country in which such income arises.<sup>20</sup>

Under the second approach, nexus is established on the basis of personal connection of the taxpayer to the taxing jurisdiction. So long that there is a sufficient connection with the jurisdiction, all the income of the entity is taxed in that jurisdiction. This approach is premised on the believe that such taxpayer have an obligation, because of their “allegiance”, to share the costs of running and establishing the social-economic infrastructures of a country that enable the taxpayer to produce the income.<sup>21</sup>

These approaches are formally known as the residence-base taxation and source-based taxation (or territorial taxation) respectively. These twin approaches of source and residence based taxation are not mutually exclusive. Jurisdictions often use a mixture of both. Residence-based taxation usually apply to resident of the jurisdiction and the source-based taxation usually apply to non-resident of the jurisdiction. That is, while resident is taxed on their worldwide income, non-resident is only taxed on income sourced in the jurisdiction. This is the general approach adopted by countries such as Australia, US, Canada, UK.<sup>22</sup>

### **3.1.2 Tax Treaty**

Splitting taxing rights in such manners would inevitably yield overlaps of taxing claim; for example, where there is a parallel assertion of residence and source jurisdiction by different states to the same item of income. In general, resolution is achieved by the residence jurisdiction ceding taxing rights to the source jurisdiction (ie. where the income arises). This approach is captured by the permanent establishment concept in most

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<sup>20</sup> Doernberg, R. and Hinnekens, L. (1999), *op. cit.*

<sup>21</sup> See Chapter 2 in Doernberg, R. and Hinnekens, L. (1999), *op. cit.*

<sup>22</sup> Ault, H. *Comparative Income Taxation: A Structural Analysis* (1997), Kluwer Law International, Den Haag, The Netherlands.

bilateral treaty that, broadly, only imposes tax on non-resident entity where they have some form of presence that qualifies as a “permanent establishment”. In broad terms, this refers to a place of business in the source country or a fixed location in a country from which business is transacted. In this regard, the permanent establishment concept provides an additional layer of nexus requirement on top of the usual nexus requirement under the source and residence based taxation.

In situation where there is no physical presence, the source country is generally only allowed, in the form of withholding, to tax certain items of income, such as royalties, interest and fees for technical services. The obligation is on the country of residence to give relief from double taxation where the income or capital is taxed in the country of source. Mechanisms of foreign tax credit, exemption, deduction may be used to achieve such ends.<sup>23</sup> Such principles are enshrined in either the domestic legislation or under bilateral treaty or both.

### **3.2 Source Rules**

In determining whether a particular item of income is taxable in a jurisdiction, two fundamental questions arise:

- What is the “source” of the income?
- What is the “residence” of the entity?

Well accepted source and residence rules have emerged over the years to address these questions. Since these rules are premised upon traditional transactions, the natural question that arise is whether they are appropriate for the new electronic transactions. Before this question can be addressed, it is first necessary to outline the source and residence rules adopted by various jurisdictions. The aim here is not to provide a complete catalogue of these rules, rather, the emphasis is on the identification of common theme and principle behind these rules.

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<sup>23</sup> Basu, S. (2001), *op. cit.*

## **E-Commerce: Relevance of Source and Residence Rules**

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The rest of this section highlights some key features of the existing source rules in relation to three broad categories: (i) sales of goods, (ii) use of, or the right to, use goods or intangible properties, and (iii) provision of services.<sup>24</sup> The source rules are summarised in Appendix A. The residence rules will be addressed in section 3.3.

The need to determine the source of a particular item of income arise principally from the source-based taxation approach. Also, the source of income may affect the application of other taxation rules, such as the foreign tax credit rules.

To set the stage for subsequent discussion and to put the operation of source rules in context, a generic example is presented here. P is a resident of Country X. P has a very diversified business. Amongst other, P's business provides services, sell goods, licence certain know-how or intellectual property rights that it has to its customer.<sup>25</sup> C is a customer of P that locates in, and is a resident of, another country, say Y.

Now, suppose C is a web site host and it pays for certain materials displayed on its web site provided by P.<sup>26</sup> The source question here is: where is the source of the payment? Before this question can be addressed, a threshold issue of characterisation need to be determined first.<sup>27</sup> There are two broad alternatives here: (i) a royalty, and (ii) payment for services. If it is regarded as a royalty, then the source is generally taken to be where the owner of the rights are located. In this case, it would be country X. If it is treated as a services income, then the source would be the place of performance. This may mean that country Y is the source of the payment (for example, this may be the case where P's employee set up the materials whilst located in country Y), and consequently country Y may exert source-based jurisdiction over the payment.<sup>28</sup>

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<sup>24</sup> Rules dealing with other investment incomes, ie. passive income, are not address in this paper as they are typically less relevant in respect of the type of e-commerce transactions being considered.

<sup>25</sup> A diagrammatic representation of the "flow" of various types of transactions conducted by P are contained in Appendix C.

<sup>26</sup> See Diagram 2 in Appendix C.

<sup>27</sup> Characterisation of transactions is another major issues in e-commerce. See OECD 'Tax Treaty Characterisation Issues Arising for E-commerce' (2001).

<sup>28</sup> This example is adapted from category 25 of the TAG recommendation re characterisation. See OECD 'Tax Treaty Characterisation Issues Arising for E-commerce' (2001).

### **3.2.1 Sales of Goods**

In relation to the sale of goods, the source is generally regarded to be at the point of sale, or, where title of the goods passed. Most jurisdictions adopted the former approach. This is the case with countries such as Australia, New Zealand, Canada, Japan, Germany, Netherlands, and United Kingdom.

Of course, specific rules vary within these jurisdictions. Australia has limited legislative guidance in relation to the source rules.<sup>29</sup> Reliance is placed on case laws for meaning. The generally accepted position is captured by the often quoted statement in *Nathan's* case that it is a “practical, hard matter of fact”.<sup>30</sup> That is, in Australia the question of source always involves a factual analysis of the various steps or processes involved in the derivation of that income, and then weights the importance of these steps in the circumstances of the each case.

Turning to the Europeans countries, such as Germany and Netherlands, rather than focusing specifically on source as such, the test is whether the income is attributable to some sort of fixed location. Some sort of physical branch in the case of Germany, and a permanent establishment in the case of Netherlands. Notice that the focus is on whether there is a sufficient physical presence in the jurisdiction.

In the UK the question is whether the sale involves “trading in” (usually where place of contract in the country) or whether it involves “trading with” (usually where place of contract outside country). The former is regarded as source in the UK. This requires a more or less a factual enquiry.

By contrast to the above, the US adopts an essentially contractual approach in respect of inventory type goods.<sup>31</sup> For non-inventory goods, the source is the residence of the

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<sup>29</sup> Eg. there is certain deeming rules concerning royalties, and there are statutory source rule concerning goods imported into the country such as section 39 of the *Income Tax Assessment Act 1936* Ie. if the Australia seller does something “instrumental” then it is deem to be sourced in Australia.

<sup>30</sup> *Nathan v FCT* (1918) 25 CLR 183 at 189.

<sup>31</sup> See ss861(a)(6), 862(a)(6) of the Internal Revenue Code of 1986, as amended; Treasury Regulations a1.861-7(c). Refer to Sprague, G. ‘Electronic Commerce: Character And Source Issues’

seller.<sup>32</sup> Supplementing these specific rules, the US also uses a facts and circumstance approach in situation where the transaction is seen to be tax avoidance in nature.

### 3.2.2 Use of Property

The following looks at payment for the use of, or the right to use, property, which may be tangible or intangibles. That is the character of income can be in the nature of rent or royalty.<sup>33</sup> Three broad approaches are available in theory:

1. Residence of payer<sup>34</sup>
2. Place of use
3. Place where property is located

In the US, for tangible goods or things like chattels, it is well accepted that the source of the income is the place where the property is used or may be used.<sup>35</sup> For intangible properties, such as intellectual property, the source is where the licensee is entitled to use, and is legally protected in using, the intellectual property rights.<sup>36</sup>

As noted above, in the case of Australia, there are no firm rule. It is a question requiring a weighting of the facts of the case. Case laws have indicated that factors such as place where agreement enter into, where chattels are used, where payment made may be persuasive. Like the position in the US, royalty is sourced where the property right giving rise to the royalty entitlement is located.

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<<http://www.bmck.com/ecommerce/ecomcharsouriss.doc>>. The US source rules summarised in this paper are taken mainly from this paper.

<sup>32</sup> See s865(a) of the Internal Revenue Code of 1986, as amended.

<sup>33</sup> Whilst this paper is not concern with characterisation, it should be noted that many online transactions can potentially be characterised as a royalty payment. See for example McNab, P. and Porter, D. 'Electronic Commerce: Determining Source' (1998) 1 *The Tax Specialist* 223.

<sup>34</sup> This assumes that the property is used where the payer is located and that this location coincides with the payer's residence status.

<sup>35</sup> Ss861(a)(4), 862(a)(4) of the Internal Revenue Code of 1986, as amended.

<sup>36</sup> Refer to Sprague, G., *op. cit.*

Likewise, other jurisdictions such as UK, Canada, Germany, Japan, Netherlands, and New Zealand follows similar rules.

### **3.2.3 Income from Services**

In theory, there are two alternative approaches to determine the source of income from services, including employment income:

1. The place where the services are performed.
2. The location where the services are “utilized” ; that is, where the benefit from the services are obtained.<sup>37</sup>

In most jurisdictions, the source for service income is the place where the service is performed or rendered. Of course, whilst this is usually the position in Australia and New Zealand, the place of contract that gave rise to the service may be regarded as the source in certain situation under the fact and circumstances approach.

## **3.3 Residence Rules**

Whereas the source rules is concern about the place where income comes from, the residence rules determine the residence status of the taxpayer. It is an important question to address in determining taxing rights under residence based taxation. This section surveys the residence rules. The rules applicable to individual and corporation are different and so they are considered separately below. Residence rules for various countries are summarised in Appendix B.

### **3.3.1 Corporation**

There are two general approaches in determining the residence of a corporation:

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<sup>37</sup> A third alternative may be possible in some situation. The source of the service income could be the place where the service is received (which may or may not be the place where the service is utilized). See Doernberg, R. and Hinnekens, L. (1999), *op. cit.*

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1. Incorporation test. Under this approach residence is based on the formal legal connection to the jurisdiction as evidenced by the place of incorporation. The US relies primarily on this test: all corporations formed under the laws of the United States or one of its Federal States are regarded as a US residence for tax purposes. Likewise, Japan also relied on a place of incorporation test.
2. Management and control test. This approach focuses on the economic or commercial connection that the corporation has in relation to a particular jurisdiction. This connection is determined by looking at factors such as the place of management, principal business location, or less frequently, residence of shareholders. More often countries that use this test consider central management to be located at the head office or corporate seat, for example, Germany, or at the place of director's meeting, for example in UK, Australia, and Canada.

Most jurisdictions tend to both approach, combining the traditional focused on the place of central management and control with the formal incorporation test. This is typically the case with Commonwealth countries.

### **3.3.2 Individual**

The requisite nexus to establish the residence of an individual is “personal attachment” to the jurisdiction. There are two broad approaches to identify this nexus.

1. Citizenship. Under this approach a person's political allegiance as evidenced by citizenship establishes his or her residence for tax purpose.
2. Facts and circumstances. Under this approach, residence is established by the personal, social, economic, family connection of the person. The jurisdiction with the closest connection in this regard is the country of residence.

Overall, approaches adopted by most jurisdictions, like Australia, UK, Canada, Japan, Germany and Netherlands, revolve around the latter. This approach involves the making of very wide enquiries and weighting of the facts to determine the extent of the connection. Factors that are considered include availability of a dwelling in that country, the residence of family members, physical presence, and social and economic ties. No

one factor is however decisive. Occasionally, the legislation may provide a supplementary test in terms of the number of days present in the jurisdictions.<sup>38</sup>

The United States stands out as different. It adopts the citizenship model. A person is resident of the United States for tax purposes if he or she possesses the right of permanent entry to the United States under the immigration laws. However, even with the US, an alternative tests based on physical presence is used.<sup>39</sup>

### **3.4 A Common Theme**

Source based taxation and residence based taxation have emerged as the corner stone concept in the overarching framework of international taxation. The aim is to allocate taxing rights between different jurisdictions. Over the years, the machinery effecting this has evolved: these are the source and residence rules. They each help determine taxing rights by identifying a sufficient nexus between the jurisdiction and the person or between the jurisdiction and the income. Two fundamental questions are: where did the income comes from and where is the person residing in.

It can be observed from the above that the source of income is determined by the place where certain activities or duties for services are performed, or the physical location of the income producing assets. The emphasise on this notion called “place” is obvious. That is, the conventional approach to the source based taxation is very much focus on the “place”, or, the physical presence of something or some activities.

Likewise, the residence rule focuses on “place”, or, the “place of effective management” where there is a tax treaty. Again, the nexus is established by physical criteria. Further, the operation of the rule relies on fluid and fuzzy criteria. Although there are some formality and certainty in the use of an incorporation test, the operation of residence rules

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<sup>38</sup> Typically, for example in Australia, physical presence for more than one-half of the tax year also constitutes residence unless the taxpayer can establish that he or she has usual place of abode overseas and that he or she does not intent to reside in Australia.

<sup>39</sup> In the US, a person may be treated as a resident if he or she is present in the jurisdiction thirty-one days or more and meets a cumulative presence test which looks to the days present in the current year and in the past two years.

are largely dependant on loose concept like central place of management that may be subject to manipulation with the advent of e-commerce transactions.

### **3.4.1 Source Rules, Residence Rule and Permanent Establishment**

Permanent establishment is always an issue that arise for consideration whenever tax treaties jurisdictions are involved. Conceptually, the notion of permanent establishment identifies a threshold degree of nexus whereby a country can assert taxing rights over the foreign investor. Recalling that this is also the role of source and residence rules, so does this means that source and residence rules no longer matter in situation involving tax treaties?

No. The operation of the permanent establishment notion relies, in most cases, on the source rules themselves. Under the so called “force of attraction” approach,<sup>40</sup> whereby domestic income is “attracted” to, and hence taxed in the hand of, the permanent establishment, an important question that needs to be addressed is whether the income has a domestic source. The answer to this question falls back to the traditional source rules. Even for jurisdictions that do not use the force of attraction approach some sort of physical connection is still required to claim taxing right over the income.

Further, the important point to note is that even the permanent establishment notion focuses on physical presence, just like the source and residence rules. It is premised on, and presupposed, the fact that a company has a “fixed place of business within a given geographical territory.”<sup>41</sup> A permanent establishment is generally defined as a fixed place of business, including an office, a branch, a factory or a similar location. This definition excludes places of business that are mobile.

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<sup>40</sup> Jurisdiction may also combine a limited force of attraction approach with an economic connection approach. Such an approach is found in the US where in addition to attributing domestic sourced income (other than investment income) to the PE/branch, foreign sourced income, such as income from financial services and licencing of intangibles, may also be attributed to the US branch/ PE.

<sup>41</sup> Article 5, paragraph 1 of the OECD Model Convention. See also Klosek, J. ‘Should a Web Server Constitute Permanent Establishment Under the OECD Model Tax Convention?’ (2000) 5 Cyber. Law 2.

## 4.0 IMPLICATIONS OF ELECTRONIC COMMERCE: AN ANALYSIS

This section explores the impact of e-commerce transactions on the operation of the source and residence rules identified above.

### 4.1 *Implications for Source Rules*

From the above section, it can be seen that the classic approach to source rules is to identify “the place” where certain things occurs. It has been observed that “these rules were developed for a physical world where it is difficult to do substantive business operation in a country without a fixed place of business”.<sup>42</sup> But given the intangible, ethereal, and ephemeral nature of electronic transactions, the question naturally arise as to the appropriateness or relevance of an approach that preoccupied itself with physical presence where in most modern transactions there are no readily identifiable physical elements. Whereas “the traditional methods of taxation rely on being able to verify location ...[t]he internet provides an environment in which automated functions can undertake significant business with little or no physical presence or activity.”<sup>43</sup>

The analysis below looks at: (i) sale and use of property, and (ii) performance of services.

#### 4.1.1 Sales and Use of Property

Two type of property needs to be distinguished: tangible and intangible. It is generally accepted that current source rules can readily be applied to the sale of goods, in the sense of tangible property, through electronic means.<sup>44</sup> Although the transactions are conducted using the electronic medium, there is always a physical dimension to the transaction and this aspect is not that different to a conventional sale of goods situation. The purchase of goods through the internet involves the same step as a purchase of the same item at the local stores. The only difference is that the purchaser do not need to physically go to the

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<sup>42</sup> Li, J. ‘E-Commerce Tax Policy’ (2000) 23 UNSW L J 313.

<sup>43</sup> ‘Taxation of Electronic Commerce: Residence’, available at <<http://e-tax.org.uk/articles/residence.shtml>>.

<sup>44</sup> See Sprague, G., *op. cit.* and McNab, P. and Porter, D. (1998), *op. cit.*

store to make the purchase: it is all done by the click of a few buttons.<sup>45</sup> This difference does not affect the operation of the source rule.<sup>46</sup>

In a sale of goods situation, the source of the payment is generally the place where the sales occur. This is typically where the business itself is located. In a sale involving physical goods, there are always a physical place where the order are received, goods packaged and delivered to the customer. Whilst the distributed nature of the new medium may make it harder to locate this place, but there has to be a physical place where all these activities occur. Functions involve in the process of sale, such as marketing, packaging, warehousing and the maintenance of the Web site may be located at various place, but this does not prevent the source rule from operating. After all, traditional transactions involve the same process. There is nothing peculiar about the sale of goods online that render the existing source rule obsolete.

Difficulties may arise where the property being sold or use is in the form of intangibles, such as digitised information that does not exist in physical form. In the case of leasing of computer software, the place of use is arguably the location of the computer on which the software is installed.<sup>47</sup> But is this necessarily the case? Take the case of a web site. Suppose some of the content in the form of embedded computer code on the site is under licence. Where is the code being use? Theoretically, it would be used by every computer in the world that access that web site and hence run those codes. So is the source of the income attributable to all these computers?

Again, note, it is not that there is no “place” where the property is being used or where the sale occur, the problem is that it is much harder to identified this place. Difficulties in identifying this place alone seem an inappropriate basis to render the source rule obsolete.

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<sup>45</sup> The flow of this transaction may be represented by Diagram 1 in Appendix C.

<sup>46</sup> Whilst such difference does not impact on the source rule *per se*, it should be noted that such difference raises other legal and commercial issues that are not address in this paper.

<sup>47</sup> Sprague, G., *op. cit.*

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It is submitted that a fact and circumstances approach is capable of dealing with difficulties such as these. This point is further elucidated in a latter part of this paper.<sup>48</sup>

Next, consider the situation where the source rule relies upon the place of contract; such as in a jurisdiction, like the US, that relies on the title passage rule, or, even jurisdictions, like Australia, where the place of contract is significant under the fact and circumstances approach. The concern is that under e-commerce, the “place of contract is likely to become increasingly difficult to determine” and “the determination of source will... become uncertain and capable of manipulation”.<sup>49</sup> At which point, for instance, is the title passed if the transaction is made via the internet? Is this the same as where the contract is formed? Contract is generally formed upon the acceptance of an offer accompanied by the payment of the consideration. So, for example, is the place of acceptance where the customer is located when he or she hit the “accept” icon on the web browser? Or is it when the vendor receives the electronic signal containing the customer’s acceptance details? And does it matter where the vendor’s server is located?

Ultimately, this seems more like a contractual issue and so resolution is perhaps best left to contract law.<sup>50</sup> Reliance can be placed on the postal acceptance rule, which should in principle function in respect of online transaction as well as ordinary mail.<sup>51</sup> Under this principle, the source would be the place where acceptance is communicated.<sup>52</sup> Of course, depending on how the sale process is arranged or presented on the web page, question may arise as to whether it is the vendor or the customer that is accepting the offer. If the vendor’s web site constitutes a mere “invitation to treat”, then the customer response would be an offer rather than an acceptance. It thus seems that there would be plenty of scope for structuring or manipulation.

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<sup>48</sup> See section 4.3 on page 26.

<sup>49</sup> McNab, P. and Porter, D. (1998), *op. cit.* at p227.

<sup>50</sup> See Searle, P. ‘E-Commerce in Outbound Planning’ in International Tax Seminar: Current Issues in International Taxation (22nd August, 2000), Conference Paper, Taxation Institute of Australia.

<sup>51</sup> Alternatively, a contract issue such as this could be resolved, or avoided, by appropriate terms and condition in the contract.

<sup>52</sup> *Entores Ltd v Miles Far Eastern Corporations* [1955] 2 QB 327 at 332-4; *Mendelson-Zeller Co Inc v TGC Provedores Ltd* [1981] 1 NSWLR 366.

### **4.1.2 Income from Services**

The one area where significant amounts of issues arise is income from services.<sup>53</sup> A popular rule in relation to services income is the place of performance of the service. This approach can be traced back and explained by the characteristics of the world in which classic services are rendered. Historically speaking, the provider of service, be they professional or traders persons – lawyers, doctors, architects, accountants, electricians – are physically located at some place when they are rendering the particular service that they are engaged by the customer to perform. This place is also usually where the consumer is physically located as well.

The advent of e-commerce change this classic paradigm. In fact, even before e-commerce as we know it, the advancement of telecommunication technologies have meant that this classic paradigm is no longer valid. Legal advices can and do get fax to client for example. The development and expansion of e-commerce will increase the ability of service providers to use electronic means to perform services without any face-to-face interaction.<sup>54</sup> The service provider can provide the service anywhere in the world with electronic communication. In this context, the locality where services are “performed” seem fungible, liable to manipulation, and indeed raises uncertainties.

In a traditional transaction, all the possible sources of services coincide. For example, in the case of the provision of legal advice in country X for a client located in the same country, the place where service is performed, where service is received and where service is utilized would be in country X. The conclusion is therefore simple: the source is country X.

As soon as a foreign country is introduced into the transaction, the analysis becomes more complicated. This is so even for traditional transactions. Say, suppose the client is located in country Y and the advice is mailed to the client. Then the place where the

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<sup>53</sup> Although some claimed that the provision of personal services will not generally pose much problem in Australia. Refer to McNab, P. and Porter, D. (1998), *op. cit.*

<sup>54</sup> Sprague, G., *op. cit.*

service is performed (ie. country X) is different to the place where the service is received (ie. country Y). Various other permutation can be readily conceived.

In cases where the provision of services have a real world foot-print, the place of performance of services or place of utilisation should be relatively easy to identify even if the service is rendered through the internet. For example, take the case of a doctor rendering services to a remotely located patient, it seems clear that the place where the doctor is physically located is where the service is performed and where the patient is located is the place where the service is received.

However, as the degree of connection with the physical world diminishes, the source becomes harder to discern. For example, how to determine the source of income for services like advertising, or the provision of data or information to customer online. In both of these case, once the system have been set up, the process is largely, if not totally, automated. In the case of advertising, depending on the preferences or profile of the users, the program located on the server will determine the appropriate advertising banner that is to appear on the user's web browser. No one is physically involved.

### ***4.1.2.1 Location of Server or Computer***

Using the provision of advice example, but suppose that the advice is prepared entirely online and the final advice is sent electronically, say as an email attachment, to the client. Where is the place of performance? If the solicitor prepared the advice while sitting in his or her office in country X, is that the place of performance? What if the computer server, containing the legal resources as well as the word processing software, is located in another jurisdiction? Would service then be performed in that country? Arguably not, but this is definitely debatable.

Turning to the place where the service is received or where it is utilised by the client. Is it where the client is physically situated? Or is it where the server of the client's ISP is physically located? It makes sense, at least technologically, to say that the advice, represented by the email, has been received by the server, and hence, the place where the advice is received is the place where the server is located. If this is the case, then the question arise as to which server? Remember, on the internet, the message get sent from

one server to another before it finally reached its destination. Alternatively, it could be that the advice is taken to be received and used only when the client download it onto his or her computer. In this case, if the client quickly ran across the border to another country and download the email from his or her portable computer, would the service be regarded to have been received in that other country?

Thus, focus on either the server or the computer do not appear to be a realistic solution.

There are two aspects to difficulties pose by e-commerce transactions. One, the medium is non-physical, making it very abstract and very hard for physical being like us to comprehend, visualise and locate. The second, and more important aspect is that the internet medium is inherently flexible, which is a blessing and a problem. Even if it is agreed that the email is received where the client's computer is located or where the ISP server is located, the fact is that the location of these devices can easily change:<sup>55</sup>

“The central issue raised by these technological possibilities is ... that processing could conceivably take place in any country that has computers that are connected...”

Under the revised commentary to Article 5, the OECD indicates that a web server may constitute a permanent establishment of the enterprise that operates the server.<sup>56</sup> This does not mean, however, that the location of the server can be relied upon to determine the source. The problem is that the person that operates the server may not, and usually is not, the same person that carries on business through the web site!

### **4.1.2.2 Agents and Contractors**

In a business environment where outsourcing is increasingly popular, and where virtual corporations proliferate, the use of agents and contractors as part of the business process are likely to be increasingly prevalent. In the context of modern e-commerce services

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<sup>55</sup> Doernberg, R. and Hinnekens, L. *Electronic Commerce And International Taxation* (1999), *op. cit.*

<sup>56</sup> OECD Committee on Fiscal Affairs, ‘Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5’, 22 December 2000.

agency relationship could arise from services such as site design, content creation, software installation, credit card processing, transaction record keeping, marketing and promotion.

The fluid and collaborative nature of these sort of cooperation in e-commerce transactions makes the source of income even harder to distinguish. For example, in a situation where an entity contracts with a third party for the performance of activities that constitute inputs to the principal's own provision of services, the question arise as to whether the activities of the agent should be considered in applying the source rules. Although, this is an issue that need to be faced by all multi-national enterprises involve in cross-border transactions, and is not an issue specific to e-commerce, the online environment makes the analysis more complex.<sup>57</sup>

A creature of modern technology is a thing called "software agent". Software agent can make decisions and conclude contracts using a digital signature in the name of its principal. Like a human agent, a software agent can be given a set of parameters within which it can make decisions without contacting its principal. Unlike the traditional agent who physically exist somewhere, a software agent only exist in cyberspace. If the use of traditional agent poses issues such as those raised above, software agent would compound the issues because their abstract and non-physical nature.

Consider the above legal advice scenario. Suppose the client in country Y click on a hyperlink on the their browser in country Y which cause the downloading of an interactive program from the legal firm's server in country X. This interactive program provides "standard advice" to the country Y customer based on the responses entered by the client on their computer. The computer program in this case is the software agent. Does this means that the service is being performed in country Y because the 'agent' is conducting the activities in country Y?

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<sup>57</sup> Whilst it is beyond the scope of this paper to consider, it should be noted that the presence of an agent or contractor would take on another dimension in tax treaty jurisdictions: it may affect whether there is a permanent establishment.

## 4.2 Residence Rules in E-Commerce

### 4.2.1 Corporation

The place of incorporation test should not pose any issue under e-commerce. Difficulties would arise from rules that look to the central place of management and control, because as with source rules, the focus is once again on the geographical notion of “place”. Traditionally, the place of central management and control is regarded in most Jurisdictions,<sup>58</sup> as in the case of Australia,<sup>59</sup> to be the place where directors meet to conduct the business of the company. This is easy to determine in the traditional business, where directors gather together in one room to conduct the meeting. The country where that ‘room’ is located is the country of residence. With the advent of modern telecommunication technologies, such traditional mode of business operation is fast changing. With devices like the modern telephone, video conference, the need for directors to be in the same room has been eliminated. The problem is best summed up by this quote:<sup>60</sup>

“The residence of a company has always been an artificial construct because a company is an artificial construct... The artificiality of a company’s residence is heightened where managers and employees of a company can reside in different jurisdictions, doing their work and communicating through the internet or other electronic means.”

Moving further into the future, with development such as virtual reality, directors of company can conduct meeting in a “virtual room” with directors located in different localities wearing their virtual reality head-gear or perhaps even some form of cybernetic implant. In such a scenario, is the “virtual room” the place of meeting? This virtual room has no physical existence. It only exists in a server somewhere. So is the physical location of the server taken to be the place of central management and control? As in the case of

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<sup>58</sup> Ault, H., *op. cit.*

<sup>59</sup> *Koitaki Para Rubber Estates Ltd v FCT* (1940) 2AITR 136.

<sup>60</sup> Doernberg, R. and Hinnekens, L. (1999), *op. cit.*

source rules above, this seems inappropriate because it heightened the possibility of manipulation.

It may be that the place where directors are physical located should take primacy. For example, the jurisdiction where the majority of director is located when conducting the meeting could be the residence. But then, the high mobility of people in this age means that the place of management is equally as fluid and equally as subject to manipulation. And how to deal with dead-lock situation where there are equal number of directors in two jurisdictions? By looking at the respective voting power of each director or their contribution to the meeting? And what if all the directors are located in a different jurisdictions, which is highly likely in a multinational corporation?

Even where there is a tax treaty, such residence-residence conflict may not be easy to resolve under e-commerce.<sup>61</sup> Tax treaty, typically resolves this conflict through the tie-breaker article where residence is taken to be the “place of effective management”.<sup>62</sup> However, the problem is that the determination of the place of effective management raises the same issues and hence the same difficulties as those noted above!<sup>63</sup>

The difficulties and issues that may arise does not look easy, but it seems that a substance over form test, like the “place of effective management” test and the more generic fact and circumstances approach, is far better than the incorporation test. The latter may be simple and clear-cut to administer, but the ease of company registration means that a tie-breaker based on incorporation can readily be exploited.<sup>64</sup>

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<sup>61</sup> A further issue is where the place of effective management is in a third State; ie. not one of the two Contracting States in a bilateral treaty. Such a scenario is increasingly probably in the context of e-commerce.

<sup>62</sup> Paragraph 3 of Article 4 of the OECD Model Tax Convention.

<sup>63</sup> Refer to OECD ‘The Impact of the Communications revolution on the Application of “Place of Effective Management” as a Tie Breaker Rule’.

<sup>64</sup> Further, reliance on place of incorporation as a tie-breaker is akin to shifting toward residence-based taxation. Such an approach is under heavy criticism and is unlikely to be favoured by revenue authority around the world, except the US as the majority of e-commerce firms to this day tend to be incorporated there. See Reuven, A. ‘International Taxation of Electronic Commerce’ (1997) 63 Tax Law Rev. 507.

### **4.2.2 Individual**

Residence rules governing individual are not immune from the challenges pose by e-commerce. Residence rule based on citizenship will not be affected, but those that looks to the lifestyle of the person would face new challenges. This paper only covers this issue in passing as the residence of individual is of minor significance in e-commerce transactions, and importantly it appears that the current approach could adequately address issues that may arise in that the e-commerce environment merely provides more facts to be considered. The process of analysis remains the same.

## **4.3 *Relevant or Not?***

The possibilities outlined above are certainly not exhaustive, but they highlight the range of issues that may arise in the world of e-commerce. Such issues do make the existing source and residence rules appears incompetent and unsatisfactory. This leads to the heart of the issue address by this paper: Are source and residence rules relevant to e-commerce transactions? The short answer is that these rules are just as relevant in this new medium as they have ever been. Drawing together some of the loose threads in this paper, the reasons for this are presented below.

### **4.3.1 Continuing Validity the Core Concept**

Traditionally, source-based and residence-based taxation formed the twin pillar of the international taxation framework facilitating the delineation of taxing rights between jurisdictions. Decision rules have evolved over time as a mean to effect this division of taxing rights. These are the source and residence rules whose main function is to identity the requisite nexus between the jurisdiction and the income, or the person, so as to justify the assertion of taxing right.

Division of taxing rights between different jurisdictions is as much a necessity back in the time of the League of Nation as it is now in the world of e-commerce transactions. Indeed, with the speed and flexibility of e-commerce, and a growth rate that is not restricted by geographical border, the incidence of cross-border transactions would only increase. This makes the need to determine taxing rights all the more important. It follows that there is a continuing need for source and residence rules.

This begs the question: why rely on existing concept? One answer is that it is conceptually solid.<sup>65</sup> A second reason is that it is more appropriate to view the technology, like the internet, as nothing more than a medium, a channel that facilitates the transaction. An analogy is that of the postal service. Mail get sent from one mail sorting centre to another, and mail is normally not regarded as being received until it arrived at the person's mail box. Electronic transmissions of the email containing the advice should be no different. This view is also consistent with the principle of neutrality.<sup>66</sup> The third reason may be summed up as: "if it ain't broken, why fix it."

Putting this another way, the use of source and residence rules as the basis to determine taxing rights have a well established history. They have been developed over 75 years ago and enshrined today in over a thousand bilateral treaties. They are well tested and well accepted by jurisdictions around the world. To adopt a completely new basis of taxing e-commerce transactions would likely create more problems than those it aims to solve. A particular difficulty with any new conceptual approach is that it is likely to result in gross double taxation, unless all, or at least substantially all major trading nations, agree to adopt the new conceptual approach simultaneously.

Take the approach of the so called "bit tax" that has been put forth a few years ago. It has not gain much positive reception and is largely dead by now. In broad terms, this approach attempts to impose tax on the individual 'bits' of information that flow through the network. Not only is this approach economically questionable,<sup>67</sup> unilateral imposition of such a tax will have anomalous double taxation consequences. Consider the legal advice example again, suppose country Z decides to unilaterally impose a bit tax such that it will impose tax on any bits of information flowing through its network.<sup>68</sup> If in sending the advice, the information needs to be routed through country Z's network, then

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<sup>65</sup> See to Forst , D. 'The Continuing vitality of Source-based Taxation in the Electronic Age' (1997) 15 Tax Notes Int. 1455, for a detail discussion of how source-based taxation remain conceptually valid in e-commerce.

<sup>66</sup> See to section 4.3.4 on page 32.

<sup>67</sup> It could increase the cost of accessing the internet, and impede the free flow of information. It also fail to distinguish between free information and those that should be charged for. See Kellenher, D. 'Taxing the Internet' (1998) 148 New Law J 438.

<sup>68</sup> See Diagram 4b in Appendix C.

all of a sudden country Z would be asserting taxing right over the transmission as well as country X.

### **4.3.2 Operation of the Rules**

The difficulties is not so much that source or residence rules are conceptually inappropriate in the new medium, rather the issue rests with the practical application of the rules. A distinction needs to be made between the conceptual basis behind the source and residence rules and the routine manifestation of those rules in practice. On a conceptual level, as noted above, the source and residence rules establish a nexus to enable tax to be imposed. On a practical level, this is translated to basic rule of thumb, such as source is the place where services are performed, to determine whether there is in fact a sufficient nexus for the jurisdiction to assert its taxing rights.

It is submitted that the underlying concept can and will adapt to meet the challenge posed by e-commerce. Despite the reference to “place” in most existing rules, there is nothing in the conceptual basis that confines the operation of the rule to the physical world; rather, the conceptual basis of the rule is one based on connection. The question these rules address is whether an entity has the requisite nexus with the jurisdiction for that jurisdiction to exert its taxing authority. In a sense, as one commentator put it, the “‘physical presence’ is and probably will remain a key concept in determining whether source-based tax liability is triggered in the context of e-commerce...”<sup>69</sup>

The point to note here is that existing source and residence rules are nothing more than ‘rule of thumb’ that have been evolved over time by the Courts, and in some cases entrenched by legislation, to cater for ‘typical’ transactions. The evolution of these rules is but a function of the features of traditional transactions or categories of income. There is this focus on “physical presence” (e.g. an office, retail outlet) because the traditional transaction is predominantly, if not solely, physical. It is also practically convenient to design rules that are easy to apply. Such ‘rule of thumb’ are not fixed: they are but a

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<sup>69</sup> Andrews, W. ‘A Platform for International E-Commerce Tax Rules: Part 1’ (2001) 12 J. of Int. Tax. 44.

convenient mean to operationalise the conceptual requirement to identify a nexus between the jurisdiction and the person or the income stream.

Now that ‘typical’ transactions have changed, or rather another ‘typical’ set of transactions are emerging, it is necessary to return to the conceptual basis, and start developing a new set of ‘rule of thumb’ to address the transactions under e-commerce. Further, to enhance certainty and consistency, it may be that additional commentaries can be made to the OECD Model Convention to document some of these rules of thumb as they emerge.<sup>70</sup>

### 4.3.3 A Factual Analysis Approach

The common approach that lies behind the current source and residence rules is the so called fact and circumstances approach. This an approach that is favoured by the Courts in most jurisdictions. For instance, case laws in Australia requires all transactions to be broken down into its different components or steps. These components are then weighted in light of the overall transaction to ascertain their relative significance.<sup>71</sup> It is through this process that source is identified.

Likewise, in the US authorities exist to support an approach that look at the activities being conducted to determine which one is more important and hence can ascribe the source to it.<sup>72</sup> Reference can be made to the US case of *Piedras Negras*<sup>73</sup>. In that case the taxpayer earned essentially all of its income from the sale of advertising time on a radio station that broadcast from a transmitter in Mexico, just over the border from Texas. In the course of their judgement the Court stated:<sup>74</sup>

“[The source of income] is not a place, it is an activity or property. ...

Thus, if an [item of] income [is to] be taxed [in the United States], ... the

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<sup>70</sup> Of course concerns can be raised as to whether modifications to OECD commentaries are necessarily binding on Contracting State that concluded their treaty before the amendment. See Vogel, K. ‘the Influence of the OECD Commentaries on treaty Interpretation’ [2000] Bulletin - Tax Treaty Monitor 612.

<sup>71</sup> *Nathan v FCT*, *op. cit.*; *FCT v Mitchum* (1965) 113 CLR 401.

<sup>72</sup> See discussion in *Sprague, G.*, *op. cit.*

<sup>73</sup> *Piedras Negras Broadcasting Co. v. Commissioner* 43 B.T.A. 297

<sup>74</sup> *Id.* at 309.

property or activities out of which the income issues or is derived must be situated within the jurisdiction so that the source of the income may be said to have a situs in this country.”

It is interesting to note that the court focuses not on the place, but on the activities or property out of which the income arise. Further, it is also apparent from the judgement that where value is created is an important consideration.<sup>75</sup>

Indeed, it seems more practical, and consistent with economic reality to adopt a factual analysis approach whereby the activities of the business are examined and weighted to ascertain the “true” source of the income.<sup>76</sup> Such an approach would focus on activities being conducted and values being added in the steps forming the e-commerce transactions, and perhaps would not dissimilar to the fact and circumstances approach that is used in many jurisdictions such as Australia.

Therefore, it is submitted that, rather than adopting a radically new approach, a better approach going forward is a return to, or perhaps a reemphasis of, the factual analysis approach. No radical shift is required. New rules are essentially evolved to deal with the emerging body of e-commerce transactions.

This approach would have the flexibility to address many of the issues raise previously in this paper. Consider the issue raise by the use of agent in e-commerce transactions. The fundamental question is: are they the source of the income or should it be that of the principal? By breaking the transactions into different stages and examining the activities being conducted in each stage, the real source of the income should be more apparent.

In adopting such an approach, activities that are preparatory and ancillary may be distinguish to those that are associated with the delivery or are integral to the transaction,<sup>77</sup> such that those that are preparatory or ancillary can be regarded as

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<sup>75</sup> Sprague, G., *op. cit.*

<sup>76</sup> This is an approach that is adopted by the Inland Revenue Authority of Singapore. See Inland Revenue Authority of Singapore ‘Income Tax Guide on E-Commerce’ (2001), available at <[http://www.iras.gov.sg/Ec/Ec\\_frame.htm](http://www.iras.gov.sg/Ec/Ec_frame.htm)>.

<sup>77</sup> Sprague, G., *op. cit.*

irrelevant and hence will not be regarded as the source of the income. This would not be dissimilar to the logic behind the treatment of a web server in the recent amendment to the Commentaries of the OECD Model Convention: a web server is view of as merely a mean to display advertising or other information, and as such, without more, will not result in a permanent establishment. This is consistent with the current approach that exclude facilities that are merely preparatory or auxiliary to a company's main business functions from being treated as a permanent establishment.<sup>78</sup> An analogy in a traditional business would be a warehouse, which do not normally result in a permanent establishment by itself.

Return to the example raise previously, concerning the automated provision of a "standard advice".<sup>79</sup> Superficially, the software agent is the one that collates and analyses the data, and then generates the advice. But a closer examination of the value adding activities involved is more revealing. The knowledge based or heuristic contained within the software agent program do not arise by themselves, at least the level of artificial intelligence technology have not advance to that stage yet, nor perhaps in the foreseeable future. Someone or more likely a group of people are responsible for the creation of this knowledge base and the heuristic rules that enable the agent to generate the standard advice base on the inputted data. Analysed in this manner, it would seem clear that the source is where these activities occur.

This does not resolve all the issues. Activities carried on by an enterprise is never simple; they are all interlinked and they could occur in different places. For example, a company may have R&D personnel in one location, operations personnel in another location, and administrative personnel located in a third location, sales and marketing personnel spread throughout the world, and some or all of these activities may even be outsourced. In this new medium the source rules need to recognise that there could be instances where income have more than one source. The attribution of income to only one source may not

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<sup>78</sup> Hardesty, D. 'International Income Tax Update' (1999), available at <<http://ecommercetax.com/doc/070999.htm>>.

<sup>79</sup> The example is in section 4.1.2.2 on page 22.

be an accurate reflection of the economic reality. Ultimately, this comes down to an allocation or apportionment issue that is itself worthy of a separate paper.

#### **4.3.4 Neutrality**

Under the Taxation Framework Conditions agreed upon by governments and businesses at the October 1998 OECD Ministerial Conference, entitled “A Borderless World- Realising the potential of Electronic Commerce”, a key consensus is that the same principles that apply to taxation of conventional commerce should equally apply to e-commerce. In particular, the concept of “neutrality” is endorsed- “taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic commerce.”<sup>80</sup>

Under the principle of neutrality, tax rules should not distort economic choices, market structures or commercial activity. On this basis income should be taxed on the same basis as under traditional commerce involving physical transaction. Thus, if source and residence based rules are continue to be used in traditional transactions, it would be contrary to this notion of neutrality to adopt anything other than source and residence rules in the e-commerce world. Indeed, adoption of special approaches for the taxation of e-commerce “would mean that an income will be taxed or exempted depending upon the communication channel that it selects.”<sup>81</sup> This seems absurd.

## **5.0 CONCLUSION**

E-commerce transactions may involve limited physical presence, and may operate within a new business model with features that seem alien to traditional source and residence rules, but this does not mean that the existing approach to international taxation should be abandoned in favour of a different model. This paper in considering the question whether

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<sup>80</sup> OECD ‘Electronic Commerce: Taxation Framework Conditions’. Also, in a joint statement on e-commerce by Australian and US released on 13 November 1998, the same principle is endorsed. The statement is available from <<http://www.doc.gov/e-commerce/AUfinal.htm>>.

<sup>81</sup> ‘Taxation of Income Derived From Electronic Commerce- Part II’ (2001) <[http://www.rashminsanghvi.com/e-commerce\\_tax2.htm](http://www.rashminsanghvi.com/e-commerce_tax2.htm)>. This is the India report to the October 2001 IFA Conference on e-commerce.

source and residence rules are relevant in the world of e-commerce has sought to develop the argument that these rules are part of the fundamental concept within the framework of international taxation. They are core issues that are relevant now and under e-commerce.

Issues that arise in the application of the source and residence rules to e-commerce transactions are best address by renewing the emphasis on the well accepted fact and circumstances approach. Rule of thumbs developed over the years tend to disguise the operation of this fundamental approach; with changes pose by e-commerce, it is appropriate to return to the inherent flexibility of such analysis.

Due to the nature of the topic, this paper has adopted an issue oriented approach that looks at the broad principles or rules adopted by various jurisdictions. Reference to specific cases or rules are done to highlight trend or to provide more concrete illustration of the issues raised by the paper. They are not intended to be exhaustive in any way. In fact, it is acknowledged that such an approach could be defective in that it tends to gloss over finer points and distinctions in each jurisdictions. It would be most interesting to undertake a study in each jurisdictions to examine the application of the source and residence rules in those jurisdiction to e-commerce transactions.

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## APPENDIX A

### *Comparison of Sourcr Rules*

<b>Countries</b>	<b>Payment for Services (inc. employment)</b>	<b>Payment for Goods<sup>1</sup></b>	<b>Payment for the Use<sup>2</sup> of Property (Tangible/ Intangibles<sup>3</sup>)</b>	<b>Other Passive Investment (ie. interests, dividends)</b>
Australia <sup>4</sup>	<p>Place where duties or services are performed.</p> <p>However, if place of performance relatively unimportant, reliance may be place on location of contract formation.</p>	Place where traders (including employees or agents) conduct the sale.	<p>Rent of chattels – place where lease agreement enter into, where chattel used, where payment made.</p> <p>Royalty – where property right giving rise to royalty entitlement located.</p> <p>But royalties paid to non-resident deem to have an Australian source to the extent it is deductible to an Australian taxpayer.</p>	<p>Interest – where agreement give rise to it is entered into.</p> <p>But sometimes place of payment may be also be relevant.</p> <p>Dividend – where company earned the profit, ie. usually the place where business is conducted.</p>

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<sup>1</sup> Goods refers to chattels, inventories, merchandises.

<sup>2</sup> Payment for the disposal of land or real property is not look at as it is rarely relevant (if at all) to e-commerce transactions being considered in this paper.

<sup>3</sup> Eg. know-how.

## E-Commerce: Relevance of Source and Residence Rules

United States	Place where services are performed.	Inventory – place where title pass.  Non-inventory – place of residence of seller.	Tangible property – situs of property.  Intangible property (including royalty) – where property used.	Interest – residence of obligor.  Dividend – residence of corporation.
United Kingdom	Place where duties or services are performed.	If trade carried on in UK <sup>5</sup> – depends principally on where management and control is exercise, not where day-to-day transactions occur.	Royalty – where right giving rise to it located	Interest – where agreement or security give rise to the it is located.  Dividend – residence of paying company.
Canada	Place where duties or services are performed.  But for director’s fee – where meeting held.  But for commission – where sale effort is	Place where sales are usually completed.	Rent of chattels – where property is located.  Royalty – where property right give rise to it is located.	Interest – residence of debtor.  Dividend – residence of payer corporation.

<sup>4</sup> A fact and circumstance test applied across the board. It is, as the often cited statement in Nathan’s case said, a “practical, hard matter of fact”. The factors identified in this table represent the determinative factor in typical cases; but the Australian jurisprudence requires that a factual analysis be performed and all factors be weighted in the circumstances each case.

<sup>5</sup> UK tax rule does not look at source as such; rather it focuses on where the trade is carried on. Non-resident only get tax on part of profit attributed to trade “carried on” in UK.

## E-Commerce: Relevance of Source and Residence Rules

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	expended.			
Germany	Place where duties or services are performed.  For professional services – if carrying on activities in Germany, rather than presence of a branch.	If trade carried on in Germany. This requires some form of physical branch or a permanent representative.	Royalties – residence of beneficial owner of rights.	Interest – where entity providing interest is located or where secured against property in Germany.  Dividend – where company earned profit, ie. usually where business is conducted.
Japan	To the extent connected with work carried out in Japan and value of asset situated in Japan.  Advertising activities – where performance occurred.	If there is no foreign manufacturing – where sale is made. <sup>6</sup>  If manufacture abroad (full or in part) – allocation required on arm’s length rule.	Immovable property – location of property.  Royalties – taxed where payment made in respect of properties of a person carrying on business in Japan.	Interest – national, local government bond, debenture by domestic corporation, deposit with entities having a place of business in Japan.  Dividend – if from domestic corporation.

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<sup>6</sup> Japan has other very details rules as well. But as these are not be relevant to e-commerce they are not summarised here.

## E-Commerce: Relevance of Source and Residence Rules

Netherlands	Place where duties or services are performed.	If activities carried out constitute a permanent establishment in Netherlands; ie. if business carried on via a 'fixed place' of business	Royalties – where property right giving rise to entitlement located.	Interest – source not relevant as tax liability depends on residence.  Dividend – place of residence of company that generated the profit.
New Zealand	Place where duties or services performed.  However, if place of performance relatively unimportant, reliance may be place on location of contract formation.	Place where traders (including employees or agents) conduct the sale.	Chattels – where right to use them in NZ and payment made by NZ resident.  Royalties – where property right giving rise to entitlement is located.  Also deemed NZ source to the extent deductible in NZ.	Interest – where loan made  But of if lent outside NZ, a deem NZ source arise if loan to NZ resident, or use by non-resident business carried via a fixed establishment in NZ.  Dividend – residence of company.

Source: CCH, *International Tax Planning – Expatriates & Migrants*; CCH, *Australian Master Tax Guide 2001*; CCH, *International Master Tax Guide 2001*, CCH Australia Limited: Sydney

## APPENDIX B

### *Summary of Residence Rules*

#### 1. Corporation

Countries	Place of Incorporation	Central Management & Control
Australia <sup>1</sup>	√	√ <sup>2</sup>
Canada	√	√ <sup>3</sup>
Germany	√ <sup>4</sup>	√ <sup>5</sup>
Japan	√	-
Netherlands	√	√ <sup>6</sup>
New Zealand	√	√ <sup>7</sup>
United States	√	-
United Kingdom	√	√ <sup>8</sup>

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<sup>1</sup> In addition, as a residual test, a company is also resident of Australia if it trades in Australia and its voting power is controlled by resident shareholder.

<sup>2</sup> This requires a fact and degree analysis, but is typically regarded as where director meet to conduct business.

<sup>3</sup> Typically, regarded as where board level decision are made.

<sup>4</sup> In Germany the test is whether the company has its “statutory seat” in Germany. However, as all corporations formed under German corporate law are required to designate a statutory seat in the Germany, the test is effectively one of place of incorporation.

<sup>5</sup> The focus here appears to be more on day-to-day management rather than the supervisory activities of the board.

<sup>6</sup> As in Germany, the focus here appears to be more on day-to-day management rather than the supervisory activities of the board.

<sup>7</sup> The New Zealand test also look to see whether the company has a head office in New Zealand.

<sup>8</sup> A critical question is whether crucial, board-level decision are made in UK. A substance based approach is adopted by the UK Inland Revenue Authority such that the place where physical meeting occur is not determinative.

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Source: CCH, *International Master Tax Guide 2001*, CCH Australia Limited: Sydney; Ault, H. *Comparative Income Taxation: A Structural Analysis* (1997), Kluwer Law International, Den Haag, The Netherlands.

### 2. Individual

Countries	Test
Australia	Four tests: <ul style="list-style-type: none"><li>▪ Resides in Australia, except if permanent place of abode outside Australia – requires a weighting of the facts in the circumstances of the person;</li><li>▪ domicile</li><li>▪ 183 day rule, and</li><li>▪ superannuation.</li></ul>
Canada	Factual analysis, considering factors such as: <ul style="list-style-type: none"><li>▪ Social &amp; economic ties</li><li>▪ Family members and dependants resident in Canada</li><li>▪ Home suitable for occupation is available for use</li><li>▪ Intention to return</li><li>▪ Physical presence over certain time period</li></ul>
Germany	Primary reliance on “domicile”. Consider factors such as: <ul style="list-style-type: none"><li>▪ Duration of presence in country;</li><li>▪ Purchase or rental of a home;</li><li>▪ Presence of dependent family;</li><li>▪ Broader social and financial association.</li></ul> Also looks at habitual residence – ie. where circumstances of the person indicate he or she is not there temporarily.
Japan	Domicile in Japan, considering factors like:

## E-Commerce: Relevance of Source and Residence Rules

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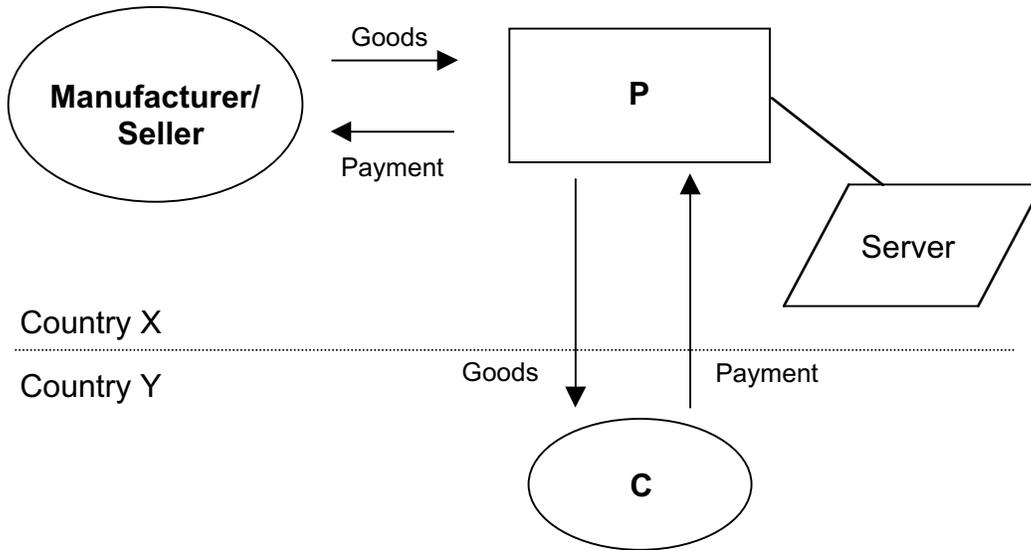
	<ul style="list-style-type: none"><li>▪ Duration of presence;</li><li>▪ Purchase or rental of home;</li><li>▪ Employment or business activities;</li><li>▪ Present of dependant family.</li></ul>
Netherlands	<ul style="list-style-type: none"><li>▪ Fact and circumstances approach, especially place emphasis on presence of a home in Netherlands</li></ul>
New Zealand	<ul style="list-style-type: none"><li>▪ Fact and circumstances approach</li></ul>
United States	<ul style="list-style-type: none"><li>▪ Permanent resident of US</li><li>▪ Substantive presence test ie. 183 days rule</li></ul>
United Kingdom	<p>Looks to facts and circumstances such as:</p> <ul style="list-style-type: none"><li>▪ Physical presence</li><li>▪ Nationality</li><li>▪ Past history as to residence</li><li>▪ Present habits and mode of life</li><li>▪ Frequency, regularity and duration of visits</li><li>▪ Purpose of visit, purpose of absence</li><li>▪ Family and business ties</li><li>▪ Whether place of abode maintain in UK.</li></ul>

Source: CCH, *International Tax Planning – Expatriates & Migrants*.

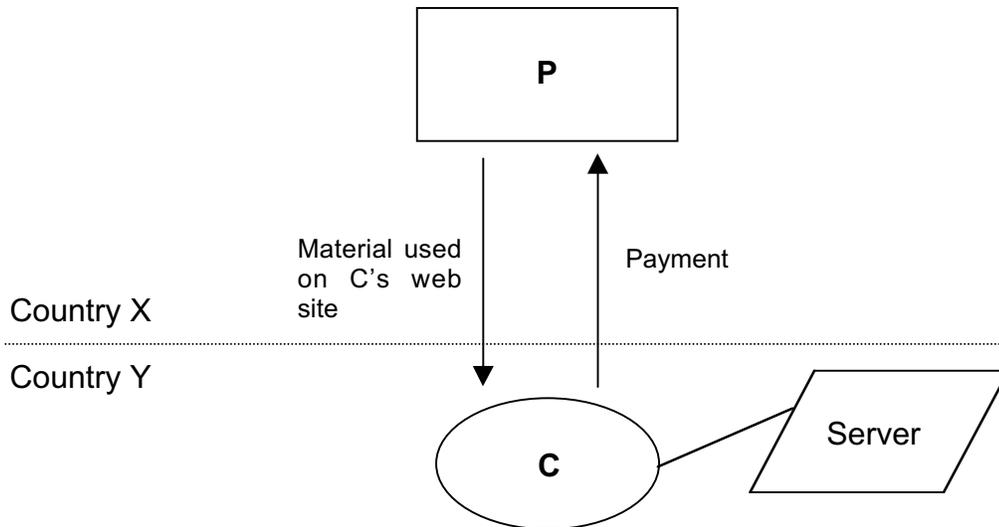
## APPENDIX C

### *Various E-Commerce Transactions*

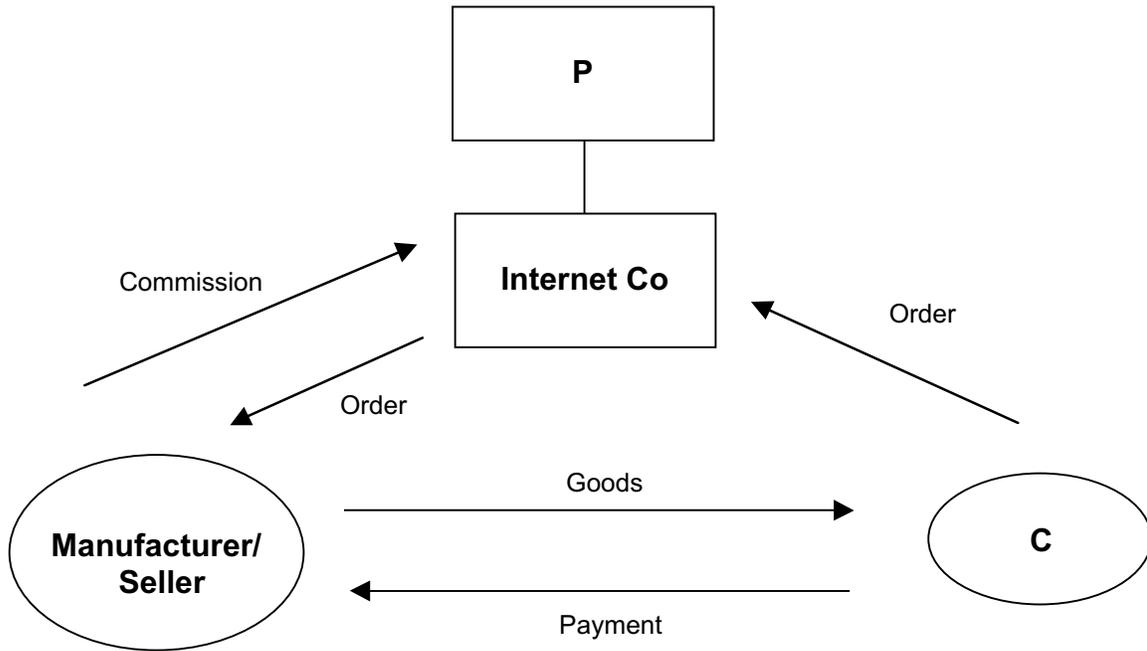
**Diagram 1 – Sale of Tangible Property via Internet**



**Diagram 2 – Web Hosting**



**Diagram 3 – Provision of Non-Digital Services**



**Diagram 4a – Provision Services in the form of Advice**

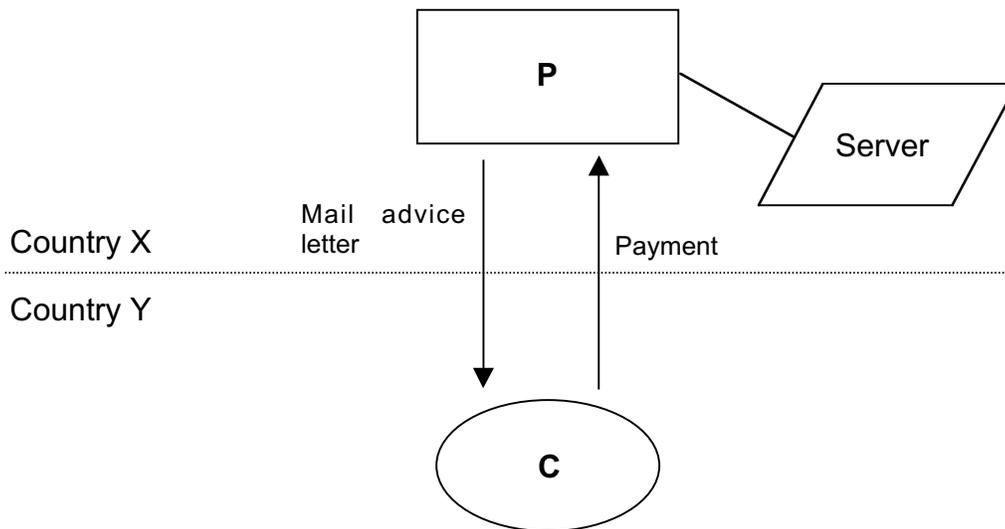


Diagram 4b – Provision Services in the form of Advice

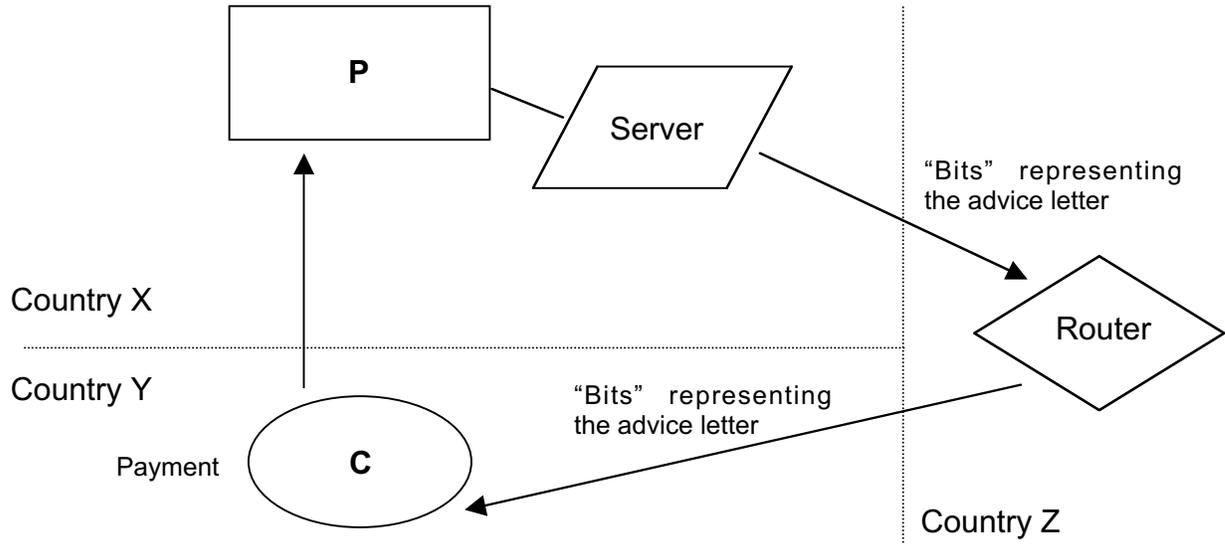


Diagram 5 – An Example of Activity and Transaction Flow in A Typical E-Commerce Business

