

The Advent of Online Business in Tanzania: The Riddle of Permanent Establishment and Tax Avoidance

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Abstract

The astonishing growth of the internet has given rise to the concept and practice of electronic commerce (online business), which has transformed how business is conducted on the planet today. Regardless, it has caused issues with tax assessment in the digital economy. Despite the critical role that the digital economy has played in altering how businesses are conducted, it has been criticized for encouraging tax evasion and loss. Tanzania's current tax law regards corporate residence presence as a Permanent Establishment (PE) as the nexus determining requirement for tax imposition. Even though the notion has mainly succeeded in the past, the rise of the digital economy has produced several obstacles and issues about whether the concept must be reconsidered regarding digital economy taxation. This is owing to the advent of new difficulties, such as traditional corporations bearing a more significant tax burden than digital enterprises, which face tax rates near zero in countries with a significant market share.

Keywords: Permanent Establishment (PE), digital economy, Tax avoidance in Tanzania

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1.0 Introduction

The continuing globalization of world economies and improvements in information and communications technologies have brought into further focus the question of whether maintaining present international tax standards is an effective method of taxing international transactions. Because national borders are no longer necessary in today's internet trade, it presents more complicated issues than conventional business. A transaction can occur in a country where the Tanzanian government has little or no presence, prompting tax officers to go wild in determining their jurisdictional power to tax the money earned by such transactions (Magoge J.S & Hashimy, S.Q, 2023). In many respects, the debate over residency versus source-based taxes precedes the debate over internet business activities. Thus, most tax systems use either the residency concept or the source principle entirely. The prevailing international tax system, which taxes corporate earnings solely in the source country if a Permanent Establishment ('PE') exists, is a balance or compromise between the two systems. A link or tax nexus between a nation and the income must be established before the country may collect a tax on it. For example, the resident nexus taxes citizens on their earnings globally, but the source nexus taxes people on income generated inside the country's physical borders (Oguttu, A.W & Tlad, S, 2009). When a multinational company establishes a subsidiary in another country, the subsidiary is considered a separate legal entity that is taxed in that country as a resident. Suppose a business entity is not considered a resident of the jurisdiction in which it is located. In that case, that jurisdiction cannot tax its income unless the business profit can be traced to a permanent establishment (PE) in that jurisdiction. A Permanent Establishment allows the nation from which the non-resident obtains the income (the source country) to tax the revenue earned. As a result, the PE concept is based on the assumption that a firm must have a physical presence in order for the source nation to tax its income. The transition in business models from conventional physical distribution to electronic delivery (e-commerce) due to technological advancement makes determining taxable presence in a particular jurisdiction more challenging.

1.1 Methodology

The study employed a doctrinal research methodology. The main concern was on the legal doctrines relating to the riddle of Permanent Establishment and the taxation of online business models in Tanzania. The study employed descriptive, comparative, and analytical methods by locating and reading the sources to analyse the

legal principles. Upon successfully locating and reviewing the documents, the researcher, with the help of logic and reasoning, synthesized the principles in context and aligned them with the study objectives to arrive at conclusions. The research analyzed the doctrines qualitatively. However, minimal statistical information will be relied upon to justify some contentions.

1.1.1 Sources of Information

The researcher relied upon primary and secondary sources. Primary sources include the national constitution, legislations, precedents, customary/general principles of law, international treaties, and declarations dealing with the concept of Permanent Establishment and taxation of online business models. Secondary sources relied upon include information obtained from various books, reports, journals, periodicals, committees' recommendations, and online databases from various websites.

2.0 The Riddle of Permanent Establishment in Tanzania

Multinational companies have generally sought to enter foreign markets by creating physical intermediaries within the target country before deploying technology. Retailers, for example, have begun marketing efforts in international regions through sales offices (Schaffner, 2013). These physical intermediaries typically constituted PEs under tax treaties, incurring source-based taxes (Chetcuti, J.P., 2002). However, as science and technology improve, merchants may now conduct much of their business online through a website. E-commerce behemoths like Amazon, eBay, Netflix, and Alibaba have mastered the knack of erasing physical boundaries and no longer need a physical presence in Tanzania. Other companies have frequently followed suit, removing the need for intermediaries or agents and selling their goods directly to clients and other businesses that may or may not become their agents. For instance, customers may now reserve cheap rooms on B&B applications online, as opposed to the traditional means of making a booking, which requires a phone call or a physical visit (Liganya, 2020). Another example is the ability to access NETFLIX channels; Tanzanian consumers pay online and may watch all current movies on their TV sets or communication devices. According to Statista statistics, on the whole African continent, Netflix was estimated to reach some 2.6 million subscribers by the end of 2021 out of a population of about 1.2 billion people. (Statista Statistics Report, 2021).

This business model lets online traders avoid the PE barrier by not having an agent, installing significant equipment and avoiding any physical presence in the country. As a result, the MNC's income from such an activity, which has a source in the United Republic of Tanzania (URT), goes untaxed, causing the government to lose significant money. This is because, as currently written, Tanzanian tax regulations fail to recognize the unique methods in which revenues are created in the digital age, notably the role of users in producing value for digital businesses.

As a result, there is a mismatch or gap between the place of value generation and the location of tax collection. This creates injustice since conventional companies suffer a more enormous tax burden than digital companies. At the same time, online businesses such as Netflix, Amazon, eBay, and Alibaba pay near-zero tax rates in countries with a significant market share. As the nexus-defining the requirements for tax imposition, Tanzania's current taxation law exclusively recognizes corporate residence presence in Tanzania as a Permanent Establishment (PE) in the source nation.

Although the concept has been largely successful in the taxation of traditional companies in the past, the emergence of the internet-based economy has undoubtedly raised the question of whether this traditional concept of PE or an alternate type of source taxation needs to be expanded or reconsidered for reasons of clarity, certainty, and enforcing. Even while the definition of PE has been restructured by the Finance Act of 2021, which adds the "agent of a non-resident" phrase in the Income Tax Act and creates a broadly defined idea of business relationship, this merely appears to be a reaction to the ever-increasing technological advances. However, the changes in question appear to be founded in the old concept of Permanent Establishment, which required a certain amount of physical permanence in the source country in order for that country to have taxing power over the MNC's revenues.

According to Section 70 of the Tanzania Income Tax Act, a person with a domestic or foreign permanent establishment's income tax liability is calculated as if the person and the permanent establishment were independent but associated persons and the permanent establishment were residents of the country where it is located. According to this clause, the expansion of the digital economy, such as e-commerce, has clearly stretched the conventional idea of the permanent establishment, which relies on a stable presence as a requirement for the government to exercise its right to tax. As a result, it is past time to rethink and reconsider the strategy to tax e-commerce by considering the notion of PE to raise government income.

As a result, digital business activities have made it more challenging to locate distant businesses that sell to residents. This is because domestic tax rules do not require an e-business to be registered in the market jurisdiction. It is also challenging to determine the scope of sales or other activities without information from the offshore seller because there may be no sales or other accounting records or other access to such information within the jurisdiction's reach.

2.1 Permanent Establishment under the Tanzania Income Tax Act

Section 3 of the Income Tax Act defines a “Permanent Establishment” to mean a place where a person carries on a business and includes a place where a person is carrying on business through an agent other than a general agent of independent status acting in the ordinary course of business as such, a place where a person has used or installed or is using or installing substantial equipment or substantial machinery; and a place where a person is engaged in construction, assembly or installation project for six months or more, including a place where a person is conducting supervisory activities about such a project.

2.1.1 Forms of Permanent Establishment

Tanzania's Income Tax Act distinguishes between two categories of Permanent Establishments: Domestic Permanent Establishments and Foreign Permanent Establishments.

Domestic Permanent Establishment means all permanent establishments of a non-resident individual, partnership, trust, or corporation situated in the United Republic of Tanzania, as defined in Section 3 of the Income Tax Act.

Foreign Permanent Establishment means all permanent establishments of an individual, partnership, trust, or corporation that are situated in any one country that is not the country in which the individual, partnership, trust, or corporation is resident but excludes a domestic permanent establishment, as defined in Section 3 of the Income Tax Act.

2.2 Taxation of Permanent Establishments.

Non-residents with permanent establishments in Tanzania must pay a 30% corporation tax on revenue earned in Tanzania. An extra 10% is applied to the actual or perceived repatriation revenue of the permanent presence in Tanzania. Whether or not the Permanent establishment has remitted the revenue, the 10% tax applies. Section 70 of the Income Tax Act treats a permanent establishment and its owner as distinct individuals.

2.3. Principles of Taxation of Permanent Establishment

The principles of taxation of Permanent Establishment are provided under Section 70 of the Income Tax Act whereby a person with a domestic or foreign permanent establishment's income tax liability under section 4(1)(a) (i.e. person who has entire income for the year of income or is a company that has a continuous unrelieved loss for the year of income and the prior two years of income calculated under section 19 of the Income Tax Act;) is computed as if the person and the permanent establishment were independent but related individuals and the permanent establishment was a resident of the nation in which it is situated. Furthermore, a person having a domestic permanent establishment is taxed on the repatriated income of the permanent establishment, in line with Sections 4(1)(b) (person who has a domestic permanent establishment that has repatriated income for the year of income) and 74 (Unallocated income of controlled foreign trust and corporation).

2.4 The need for taxation of online business

While there is no arguing that internet transactions must be taxed, the foundation for e-commerce taxes remains a mystery. The benefit theory is a fundamental principle governing a country's tax entitlement. It specifies that a state's taxing capacity is based on the overall worth of the benefits and services provided to taxpayers (Mas & Junquera-Varela, 2021) . Thus, the state needs income-generating e-commerce operations to compensate for the costs of providing public services such as favorable legal infrastructure, customer base, stable currency rates, and economic stability(Chandra, N, 2005).

Furthermore, the exemption from taxation on e-commerce results in equality. E-commerce increases efficiency by cutting procurement and transaction processing costs, and increased efficiency increases profitability. E-commerce tax exemption will consequently result in inequality since people who traditionally do business and

make less profit are taxed. In contrast, those who migrate to e-commerce and earn a more significant profit are tax-free.

Similarly, states are afraid that as e-commerce grows, more individuals may opt for tax-free online purchases, detracting from conventional ways of buying. As a result, states will lose critical revenue.

2.5 Determination of permanent establishment and the advent of technology

The permanent establishment is formed when the enterprise begins to do business via the location of the business (Reimer et al., 2018). When the abovementioned activity differs significantly from the activity to be carried out from the place of business, the question of time in setting up the place of business is unimportant. Furthermore, when the fixed location of the business is sold, the Permanent Establishment ceases to exist.

The introduction of technology and e-commerce led to widespread Internet usage, causing the global marketplace to contract. In today's virtual world, an entity's physical presence is unimportant. The usage and role of digital information, commodities, and so on contribute to technological growth, and a foreign corporation does not require any physical presence in a nation to conduct business. As a result, the traditional definition of PE, as defined in chapters two and three, ignores technological advances that allow firms to service markets remotely with no physical presence or one that only performs support activities. Taking advantage of the weaknesses in the legislation, firms set up shop in low-tax countries and utilize technology to market their products globally.

Only automated equipment such as computers, servers, and other similar devices may be implemented to do business in the contractual state. The question of whether such automated equipment may be regarded as PE in the contractual stage has frequently arisen. Furthermore, it has been questioned whether some intangible things that aid firms in conducting business in the contracting state, such as websites and software, constitute PE.

2.5.1 Computer equipment or server as PE

Servers are devices that store information that network users may access (Radhakishan Rawal, 2006). Servers are pieces of equipment having a physical location, which may be a fixed place of business for the corporation that operates the server (OECD Commentary, 2003). According to the OECD Commentary on Article 5, PE may occur if a business operates computer equipment at a specific location, even if no personnel from that firm are required to operate the equipment at that site (Reimer et al., 2018). The most important need for establishing a fixed place of business is that the server or computer equipment in question be available to the organization. Complete control over computers installed at subscribers' premises has also been designated a fixed place of business as it held in the case of *Galileo International Inc. v. Deputy Commissioner of Income Tax*.

2.5.2 Internet website/software as PE

An internet website is a collection of software and electronic data that does not represent tangible property in and of itself and hence lacks a physical place in which to do business due to the lack of amenities such as offices or, in some circumstances, machinery or equipment. A server typically holds the website via which firms perform their operations. An internet service provider occasionally hosts a website the corporation cannot access (Reimer et al., 2018). In this circumstance, the corporation does not have a set location. provided a company conducts business via a website housed on a server owned or leased by the company and available to it, the website may qualify as PE provided additional conditions are satisfied, such as the activities undertaken being more than preparatory or auxiliary (OECD Commentary, Article 5). Thus, the underlying principle is that because a website is a combination of software and electronic data, it cannot have a physical location that serves as a place of business. However, a web server, on which the website is stored and accessible, is a piece of equipment with a physical location, and such a location can serve as a fixed place of business for the company that runs the server (Radhakishan Rawal, 2006). The position was emphasized in the case of *ITO v. Right Florists Pvt. Lt.* The Income Tax Appellate Tribunal ruled that a website does not constitute a permanent establishment unless the servers on which the website is hosted are also located in the same jurisdiction, and since Google and Yahoo's servers are not located in India, there is no fixed place permanent establishment in India.

3.0 Online business models that avoid taxes in Tanzania

Due to the advancement of technology and the growing number of internet users in Tanzania, a plethora of online enterprises are sprouting up. As a result, this section examines the architecture of the Tanzanian Internet business model that avoids taxes. As discussed below, two types of Online business Model Structures widespread in e-commerce businesses enable tax evasion..

3.1 Aggregators Model

According to the Cambridge Dictionary, an aggregator is a person or organization that aggregates information from other businesses' internet pages and places it on a single website. Aggregators are also defined as people who own and operate a web-based software application that allows a potential client to interact with others who provide specific services, such as Cabs, Hotels, and Travel Portals, using the application and a communication device under the aggregator's brand name or trade name. Aggregators in Tanzania include firms such as Uber, Bolt, Airbnb, and others. The primary tax concern is whether or not aggregators' local operating subsidiaries should be taxed, considering that they frequently provide support services to the parent firm. Because they maintain that they provide marketing and support services, they do not qualify as a Permanent Establishment. As a result, these aggregators are frequently exempt from taxation under Tanzanian law.

3.2 E-tailing Model

Electronic retailing (E-tailing) is the sale of goods and services through the Internet. Business-to-business (B2B) or business-to-consumer (B2C) transactions are both possible. This includes shopping websites. Under the e-tailing model, there are three sorts of business models in the e-commerce market. Inventory-Based Model, Marketplace E-Commerce Model, and Hybrid Model are the three options.

3.2.1 Inventory-Based Model

Shopping websites that manage the complete process from product purchase through warehousing and shipment are included. This type of inventory model is not popular in Tanzania since it is inventory-based and demands a large amount of cash. Fulfillment by Amazon (FBA), Kikuu, Darshopping, Zudua, and others are examples.

3.2.2 Marketplace E-Commerce Model

This approach follows the zero inventory concept. They are not storage facilities but rather a meeting location for buyers and sellers. In Tanzania, the Marketplace E-commerce business model is causing a tremendous surge in online buying. For instance, eBay, Kupatana, Jumia, ZoomTanzania, etc.

3.2.3 Hybrid Model

This concept is a hybrid of marketplace and inventory-based business structures. This technique allows websites to self-fulfill orders or keep products on the internet. These e-commerce platforms provide several tax issues. Amazon is an example of this.

Amazon has fulfillment centers (warehouses) where items sold on e-commerce sites are stored. Amazon handles merchandise storage, as well as collecting sales money, deducting commission, and remitting the balance to the dealer. Furthermore, when an item is purchased online, an invoice in the seller's name is prepared and sent to the consumer, but Amazon obtains a commission for its services.

It should be noted that the definition of PE in the Income Tax Act does not specify whether a warehouse is a PE. Even though Tanzania accepts and adopts the UN Models' definition of PE, Article 5 (4) of the UN Convention provides exclusions, which say that using facilities to store or display items or commodities belonging to the company is not PE. Amazon can argue that the facilitation facilities are just for storage and delivery and do not qualify as PE in Tanzania.

Furthermore, Amazon connects the seller and the client, and the vendor must ship the product directly to the customer, with Amazon just charging a fee. As a result, Amazon does not participate in the commercial transaction but instead acts as a facilitator by allowing merchants to use the e-commerce platform. Amazon is now solely an online business platform; it has no physical presence, either fully or partially, and hence does not fit under the definition of PE.

4.0 Online business models that do not require a physical presence in Tanzania and evade taxes

This section describes in detail internet business methods that do not require a physical presence in Tanzania and thereby escape tax. Social Media Websites (Applications) and subscription websites are the two types of online business models that do not require a physical presence in Tanzania.

4.1 Social Media Websites

Social media websites are online platforms that enable individuals to communicate with one another and share and create content. It also offers numerous business marketing opportunities. Examples of social media are Facebook, Instagram, LinkedIn, Telegram, Twitter, Tick tock, WhatsApp, YouTube, etc. According to Datareportal, until January 2021, Tanzania had 5.40 million social media users. Between 2020 and 2021, the number of Tanzanians using social media grew by 900 thousand (+20%). These websites are engaged in the

majority of user participation-intensive businesses, and the number of the user base and the level of involvement are essential to the business's profitability, which affects its financial performance. Most social media activities are not taxed because they are not considered PE.

4.2 Subscriptions Websites

These subscription-based business models provide customers with digital content such as information, music, and videos in return for a monthly charge. Some examples are Netflix, Spotify, Amazon Prime, Bumble, Boom Player, Westlaw, and Hein Online. The biggest issue that arises under the direct tax system is the classification of such money generated by these websites. Whether subscription-based service income should be classed as royalty or company income is unclear. Subscription-based websites do not require a Tanzanian office to serve Tanzanian customers. As a result, they generate much money from membership fees. It should be highlighted that, under the existing framework in Tanzania, a physical presence is required to create a PE. Thus, if such money is classified as business income, it is excluded from the tax regime.

5.0 The Way Forward

5.1 Amendment of the definition of PE

Amendment to the Income Tax Act to incorporate Significant Digital Presence or operations in Tanzania or with Tanzanian residents as one of the requirements that may form a PE for tax purposes, as well as to consider the BEPS Action Plan recommendations. Furthermore, amend the Value Added Tax Act of 2014 to broaden the definition of products to include virtual products.

5.2 Introducing Digital Services Tax

The imposition of a tax on digital services. Due to inherent defects, the Tanzanian Income Tax Act does not appropriately address the limits of Digital Commercial Transactions. As a result, Tanzania cannot tax the bulk of revenue made by MNEs from electronic commerce in Tanzania. As a result, new legislation dedicated to addressing these issues is necessary. The new legislation will include digital PE, customer engagement, source rules, value creation, assessment, return procedures, data collecting, enforcement, and other tax processes.

5.3 Inclusion of nexus rule in tax treaties

A nexus rule to tax treaties is the long-term solution for taxing digital business transactions. There are two ways to accomplish this. The first step is to negotiate treaty amendments with other governments. This is a lengthy procedure. During the interim term, Tanzania would prioritize negotiations with countries whose populations are significantly involved in digital commercial activities. The renegotiation of tax treaties will entail a change in the definition of PE. The second is to create a Multilateral Instrument ('MLI') that any nation can use. However, it is critical to remember that a treaty results from a negotiation process that considers the contracting parties' economic and budgetary policies. Changes to such treaties by adding an MLI will not consider specific relationships between contracting nations and may thus fail to represent each state's economic and political dynamics. As a result, not all contracting states may be willing to sign such a pact.

6.0 Conclusion

Generally, business income is taxed only to the extent that such firms have a physical presence to which the profits are ascribed. The Income Tax Act applies to global enterprises with a permanent establishment in Tanzania. According to Section 3 of the Income Tax Act, a permanent establishment can be assessed by various characteristics, such as the physical location of the business, significant commercial equipment, or the amount of time spent in Tanzania executing business operations. The notion, however, excludes online retail outlets where physical and intangible items are transferred between Tanzania and other nations. As a result of the issues of PE, there is currently a gap in the country's tax rules governing the taxation of online businesses. The existing tax legislation developed during the period of traditional commerce necessitates further measures to meet the present and future problems of e-commerce.

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