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**TAXATION OF E-COMMERCE FROM A GLOBAL  
PERSPECTIVE**

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## ABSTRACT

E-commerce dramatically heightens the dialectic relationship between public policy and technology. The shift from a physically-oriented commercial environment to a knowledge-based electronic environment poses serious and substantial issues in relation to taxation and tax regimes. Consumption taxation is one such area in taxation where there is potential for loss of revenue. During past few years, there have been simultaneous efforts from respective governments, collectively the European Union, and international organisation like OECD and WTO who are reassessing specific tax policies with respect to e-commerce and how such policies may impede or facilitate economic objectives.

There is considerable speculation as to what overall response governments will adopt towards the taxation of e-commerce. At one extreme, there is the view that e-commerce should in some sense be allowed to take place in a tax-free environment. At the other extreme, there is the speculation on the introduction of new taxes specifically designed to tax e-commerce. Neither of these views are acceptable to most of the governments.

This thesis examines the role and limitations of the present consumption tax regimes (VAT and Sales Tax) within the e-commerce environment. Specifically identifies and compares the regimes within EU and UK for VAT and US for sales tax and possible working of these regimes in an e-commerce environment. It further accesses the impact of e-commerce on developing countries where there is a potential for significant revenue loss. It also evaluates the most effective mean for collection of consumption taxes which is technically feasible, efficient, and cost-effective and proposes to utilize ISPs as a responsible authority for calculating, collecting and paying of taxes. The proposal is aimed at developing a simple, uniform, and fair system, which will reduce the burden imposed on retailers, and preserves sovereignty of the countries in case of cross-border e-commerce.

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***Dedicated***  
***To my***  
***Mother and Father***

# Chapter – 1

## INTRODUCTION

### PREFACE

Taxation has provided the backdrop to many historical, social, and administrative developments throughout the existence of organized society. Taxation (and tax collectors) has been much maligned in popular literature. Taxes have been immortally associated with other dreaded occurrences like death (for example, Mark Twain's: "*There are few things certain in life, death and taxes*"). To collect taxes presumes the existence of authority to impose and collect it. In most cases, this authority is wielded by the State.

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### 1.1 AN INTRODUCTION TO TAXATION

*"We are in the midst (or perhaps only at the beginning) of a revolution in the technology of commerce that will have important but perhaps largely unknown ramifications for the ability to levy and collect taxes. Radical improvements in our ability to store, process, and communicate information are changing the way products are packaged and delivered. Understanding these technological developments and their ramifications is necessary if we are to be successful in designing the tax policies and institutional arrangements needed to cope with them. As is often the case, it is useful to look back, to prior revolutions in information technology, to understand the future and the nature of the problems to be faced. Several times in the past, as now, developments in the technology of storage, processing, and communication of information have led to changes in modes of commerce in information and thus in the feasibility of various forms of taxation"*(McLure, 1997).

The modern state, as defined by the principle of exclusive sovereignty over a bounded territory, was born out of the fiscal crisis of medieval European feudalism, which by the 14th and 15th centuries was increasingly incapable of raising sufficient revenues to support the mounting expenses of warfare. In ensuing years, the state emerged as the dominant political organisation in Europe in part because it extracted resources through taxation more efficiently than its rivals did. In short, the modern state was able to survive and flourish because it made fiscal sense: it was a form of political organisation that was particularly well suited to taxing wealth and commerce (Paris, 2001).

In modern day UK as in all complex economic systems, the vital importance of taxation could be seen from its sheer volume. A comparison between the current volume of tax revenue in UK and the gross domestic product (GDP) would provide ample illustration of this fact. In 1998, the GDP of the UK amounted to £840 billion and that year the various departments of the Treasury and associated agencies collected £300 billion in revenue, which roughly £5000 per head.<sup>1</sup> Any system of taxation is related in some fashion to collecting for government a share of economic activity. Governments have, over the past 200 years, developed ever more sophisticated systems for taxing and regulating economic activity to meet the demands of modern society and to keep pace with advances in technology and economic growth. Hence, it could be said that taxation is the price we must pay for a civilized society. While it is true to say that just about anything could be taxed, however taxes are levied classically from certain key areas of the modern economic world. One of such key areas so taxed are the use and consumption of goods and services. In essence, although taxation effectively affects or can be said to be imposed on less tangible items, such as the gratification of an individual's real or imagined needs and desires, no administrative tax system can be based on such esoteric concepts. The system must find ways of evaluating the level of surplus resources deriving from events or the level of consumption of goods and service, in terms of a variable and broad-based medium of exchange (Craig, 2000).

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1 COI Statistics 1998

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The concept of taxation involves jurisdiction. From the '*Boston Tea Party Rebellion*' in which tea was taxed as it physically landed on American shores, to sophisticated concepts in international taxation, a government's authority to tax had always been based on territory and jurisdiction. These systems now face a serious challenge from development of e-commerce; the trade in goods and services over the Internet fundamentally has alerted accepted boundaries and conventions.

Tax systems evolved when each country formulated its own tax policy and focused on the requirements of its domestic economy. When tax treaties, agreements and conventions among nations were negotiated, they were within the framework of national sovereignty in tax policy. However, it was the globalisation, which had started to change this, particularly with respect to the level of taxation, mix of taxes, design of particular taxes, and the manner of their administration and compliance.

Globalisation has distinct effects on the tax structure and on government expenditures. With a rising degree of international integration, national governments started losing parts of their monopoly power of fiscal policy. Countries were being forced to exhibit much greater awareness of and sensitivity to the tax changes being undertaken by their trading partners and competitors, reducing autonomy concerning their tax policies. They increasingly found themselves in a situation of strategic interaction with their foreign counterparts.

Formal sovereignty is a legal concept implying supremacy within a territory and independence of outside authorities in the exercise of state authority. In contrast, autonomy and effectiveness are political constructs; the former implies that a state can and does make its own decisions with regard to internal and external issues and the latter is a measure of the extent to its purposes are achieved. In examining the impact of globalisation on taxation, one must separate the constraints imposed on autonomy, effectiveness, or capacity from impacts on formal sovereignty. Two sets of questions need to be asked. *First*, are the constraints that globalisation imposes on state autonomy qualitatively different from those resulting from the interdependence associated with an international or cross-border world economy? If so, at what point do constraints on state autonomy compromise formal internal sovereignty? *Second*, would the emergence of an electronically networked global economy compromise external sovereignty: the idea of territoriality itself as a mode of economic and political organization?

The growth of e-commerce has changed the way people do business. The shift from a physically-oriented commercial environment to a knowledge-based electronic environment poses serious and substantial issues in relation to taxation and taxation regimes. The rise of e-commerce raised fundamental questions of tax policy. Most fundamentally, should e-commerce be taxed? Would the answer be same in the short run as in the long run? What about arguments that e-commerce should not be taxed during its infancy? How would the exemption of e-commerce affect 'Main Street' merchants? What would the implications for tax revenues of exempting e-commerce? Whether a decision is made that e-commerce should be taxed or should not be, additional questions arise. If e-commerce is to be

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taxed, how should it be done? Can e-commerce actually be taxed, as it should be? What are the technological, legal, and political impediments to taxing e-commerce? What simplifications of tax laws and administration are required for taxation of e-commerce? Are there 'technological fixes' for these problems?

However, it should be noted at the outset that there is no ambiguity at present regarding the status of the goods ordered and paid for on Internet but delivered physically in the conventional manner. The problem is most obvious for intangible products, such as music, software, and services such as medical or legal consultations that are 'produced' at one location and 'consumed' elsewhere. It is generally accepted that tax rules for sale of intangible products and services should be same, as those of other goods, and that the means of delivery should not govern tax treatment. A 'technologically neutral' taxation would not treat the sale of a paperback book any differently than the sale of a digitised book. However determining which products are functionally equivalent is less easy. Is the text displayed on computer screen really the same thing as a printed book? Is a movie downloaded to computer hard drive really the same thing as a video rental? If digitised products are treated as services, then further guidance would be needed to specify which source of supply rules for services shall govern because there are many different rules for different types of services. Moreover, most of the countries do not have comprehensive taxation to services and few intangible products aside from basic utilities, which are subject to special taxes.

The final answer to these questions, which would result from policy debates and legislative actions worldwide are not clear yet. There is a great deal of disagreement on what the correct answers would be. In spite of various moratoria on e-commerce taxation, taxing services and e-commerce activities on the Internet has been the preferred long-term policy approach for most countries due to its promise of potentially huge tax revenues. However, the debate should concentrate on a global solution to the e-commerce taxation; the border-spanning nature of Internet suggests that countries should collectively, and not just individually, should agree to common ground rules for taxation of electronic services and goods. Uncoordinated, inconsistent and unpredictable taxation schemes by different countries would threaten the growth of e-commerce and could potentially cause larger losses in tax receipts in some nations than revenues.

There would always be the distinction and disagreement between *descriptive* and *prescriptive* study of policymaking. Policymaking requires both 'knowledge of' and 'knowledge in' policymaking. Despite the danger of sacrificing 'policy analysis' to 'policy advocacy', it is important to state up front that the focus of this thesis is to provide a balance between the *prescriptive* (how policies ought to be made or should be made in future) and the *descriptive* (how policies are being made or are in existence), with the rider that it should be viewed as an analysis of the prescriptions or options and it would end with the recommendation of a fixed approach.

### 1.2 CHAPTER STRUCTURE

The American writer Lewis Mumford once remarked of a new challenge, “*I am very optimistic about the possibilities but pessimistic about the probabilities.*”<sup>2</sup> The communication revolution has opened up many possibilities for tax administration to improve the efficiency of their operations. However, these same technologies have also opened up new possibilities for tax evasion and avoidance.<sup>3</sup>

Chapter-2 starts with a background discussion of the issues relating to globalisation and its influence on taxation. The Internet represents the greatest technological revolution since the industrial revolution of the 19th and 20th century. The most significant technological innovation that followed was the introduction of the World Wide Web. This chapter will provide a brief overview of the history of the development of technology for storing and communicating information and its implications for taxation, and the types of e-commerce.

The development of policies and mechanisms for a fair, equitable and enforceable tax treatment of e-commerce will need a proper understanding of the existing taxation principles, Chapter-3 provides an overview of the direct and indirect tax regimes. Since each nation has its own tax rules and the rules of one nation are rarely perfectly meshed with those of another, it is possible that income may be taxed more than once (referred to as double taxation) or that it may go untaxed by any jurisdiction. There are two bases for a state to assert jurisdiction to tax income: one is the ‘residence’ of the taxpayer earning the income and the other is the ‘source’ of the particular item of income sought to be taxed. When an individual or enterprise is potentially subject to tax in two different jurisdictions, there are frequently elaborate rules designed to prevent the multiple taxation of the same income. For such rules to be effective, there must be common understanding among the competing tax authorities as to how to measure income, when to tax it, and how to define such basic concepts as ‘source’ and ‘residence’. Even if there is such a common understanding, there must be agreement as to which basis for taxation takes precedence. On such occasions double taxation is prevented through an extensive network of bilateral and multilateral tax treaties, which attempt to allocate income earned to the source and to the residence according to ‘permanent establishment. The concept of ‘permanent establishment’ is complex, but at its heart, it relies on a substantial and continuous physical presence within a country. Consumption taxes are an important source of revenue for most of the governments around the world. They follow either the European model of VAT or US model of sales tax. This chapter contains an overview of the European VAT system and the background to the operation sales and use tax system of US.

Taxation is clearly part of a political economy. Tax principles naturally involve ethical and political questions. It is the principle means by which governments can attempt to redistribute wealth and bring

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<sup>2</sup> Craig (2000) p 13

<sup>3</sup> Inland Revenue publication *Electronic Commerce: The UK's Taxation Agenda* (1999)

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about social change through various social policies. Chapter-4 outlines principles and objective of tax policies and on jurisdictional issues.

An important effect of the Internet and of the rapid development in communications technology is to de-emphasise the significance of the place in which economic activity is carried out: source, as in which jurisdiction has the right to tax when dealing with profits taxes and property taxes and source, as in place of receipt, for consumption taxes. Thus, the specific tax implications of the e-commerce phenomenon and the threat to establish tax systems can be examined by reference to how much they tend to disrupt this concept of source based taxation and the tax treaty concept of 'permanent establishment'. The tendency of E-commerce to eliminate geographical boundaries and "*to blur . . . the source and character of income*" it would threaten the continued viability of such concepts, which include: source-based taxation the tax treaty concept of 'permanent establishment'. Chapter-5 touches on questions of international direct taxation, and the effect of e-commerce on the principles of direct taxation. The principal emphasis throughout this chapter will be on the issue of whether and to what extent a particular taxpayer or potential taxpayer can be brought into a particular tax system.

One characteristic of activity on the Internet is process known as '*disintermediation*'. This refers to elimination of or significant reduction in, the role of intermediaries such as distributors brokers from the original producer to the ultimate consumer. Theoretically, the elimination of intermediaries should not affect the fundamental results of a commercial transaction: the methodology of taxing sale of software or downloaded music from the Internet should not differ from that of the sale of the same products in physical environment. However, tax authorities all over the world have found intermediaries to be excellent compliance sentinels and transactions dealt with by intermediaries to be administratively convenient points of collection and assessment, this is particularly so in relation to indirect taxes. Chapter-6 will examine generically two different tax systems and the effect of e-commerce on them: the European VAT and the US sales and use tax. The chapter will start by describing effect of direct e-commerce on VAT. Most of the current VAT rules were developed at a time when the ability to digitise and deliver many types of goods and services cross-border was limited. It specifies the problems and establishes the serious dysfunction of the present VAT rules by closely scrutinizing the application thereof to electronic supplies. In order to have an effective international system of VAT in the context of cross-border trade, those rules must be capable of answering three questions with respect to a particular cross-border supply transaction: (i) is the transaction subject to tax? (ii) Who is required to pay the tax? and (iii) to whom should the tax be paid? However, answer to these questions will differ frequently depending on whether the supply at issue is classified as a good or a service and, if as a service, which category of service it falls. The second part of the chapter will cover the US sales tax, particularly the issues of 'nexus' and 'situs of sale'. Any application of state sales and use tax to e-commerce must be considered in the light of the decision of the U.S. Supreme Court in *Quill*, which effectively exempts many remote sales of tangible products. Conceptually pure versions of these two taxes have similar effects, but inherent administrative differences in the two taxes and deviations from the conceptual model enacted by the States or forced on them by judicial

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interpretations of the U.S. Constitution create important differences in their effects. Particularly important for present purposes are (i) the treatment of sales of services and intangible products under the two taxes (such products are generally taxable under the VAT, but not state sales taxes), (ii) the treatment of purchases by business (VATs on such purchases are almost universally creditable against VATs on sales, but many such purchases are subject to state sales tax), and (iii) the treatment of sales between jurisdictions (they are commonly subject to VAT in the country of destination but exempt from sales and use tax in states where the vendor lacks a physical presence).

All taxes, direct and indirect, under whatever jurisdiction, must operate within global economy. Where e-commerce presents its challenge to the established order is in the fact that it exists in borderless virtual world whereas conventional wisdom regulates commerce and taxation through international treaties, which rely heavily on the establishment of the location of each of the transacting parties. The most fundamental threat to the international tax system posed by e-commerce is the erosion of worldwide tax base and in consequence the damage to economic balances, economic efficiency, and competitive fairness among vendors. Chapter-7 will use the best available data in an attempt to evaluate and quantify revenue loss and its potential disproportionate effect on developing countries. There is limited published work that attempts to evaluate the effect of e-commerce would have on developing countries. The lack of systematic data sources means that on many occasions, the evidence of is potentially suggestive. However this chapter following the quantitative estimates of sales tax revenue losses from e-commerce given by Bruce and Fox (2001) and attempts to consider the effect e-commerce goes untaxed there would be substantial revenue loss for developing countries.

Chapter-8 deals with the question how to reconcile national fiscal boundaries with the borderless world of e-commerce. There is a growing environment of trust and co-operation between tax authorities and the business community, which will prove useful in the drive to reach satisfactory tax solutions in e-commerce. For obvious reasons much co-operation would be required from the governments around the world. Some that co-operation is already in evidence. Attempts by the major economic powers have been underway for last few years to address these e-commerce problems under the umbrella of the OECD, which, with agreement of the majority trading nations, developing regulatory framework for e-commerce on a worldwide basis. This process was formalised at Ottawa Ministerial Conference in October 1998 and its subsequent related review meetings, most notably in Paris October 1999. These summit meetings produced five interim conclusions or guiding protocols' for national governments and trading blocks for development of their tax policies in relation to the Internet and e-commerce (under the title Electronic Commerce Taxation Framework). These five guiding protocols are:

- Neutrality (between conventional and electronic forms of commerce).
- Efficiency (minimal compliance costs).
- Certainty and simplicity (clear and simple rules on when, where and how tax is to be accounted for).
- Effectiveness and fairness (minimising the potential for evasion and avoidance).
- Flexibility (the ability to keep pace with change).

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Similar constructive contributions have also been made by United State and by European Union. US initiative particularly in field of consumption taxation recognises the great gulf of incompatibility between the US sales tax and EU VAT. The OCED purpose was to ensure that no unilateral moves took place on the part of individual state government to regulate, inhibit, or tax Internet transactions or to discriminate against e-commerce by way of protectionist measures. However, as the chapter will show such an effort by OCED has been confronted by major contradictions and limitations.

Lastly there is also the need ensure participation of developing countries so that they can also begin to influence the 'rules of the game'. However, what would it mean developing countries to have a meaningful voice at an international table on tax policies and standards? It would almost certainly have to mean that any dialogue on development of e-commerce tax principles should also protect their interest. Any solutions must have the confidence of the developing world. *"Above all, what is needed is a recognition that globalisation is not merely a matter of unrestricted market forces. It requires a strengthening of international standards and co-operative arrangements, to provide a basis of mutual confidence."*

In order to aid the policy-based discussion, the chapter-9 begins with a very broad outline of the fundamental pragmatic and policy concerns that arise in any thoughtful consideration of changes in a system of taxation. The chapter states in broad terms the economic objectives and principles that should guide the taxation of e-commerce. It presents different proposals and options for reforming the taxation of e-commerce derived from those objectives and principles. On this, both the US and EU agree that "the taxation of commerce conducted over the Internet should be consistent with the basic principles of international taxation, should avoid inconsistent national tax jurisdictions and double taxation, and should be simpler to administer and understand".

Chapter-10 provides a proposal of how to achieve in practice for on-line collection and compliance mechanism for e-commerce. I believe that in this chapter I have identified a number of specific issues which need to be addressed in order create a definitive consumption tax compliance system .In the first instance, what is needed is a dependable and verifiable mechanism enabling a supplier to distinguish between registered businesses and private customers. Although this is not a feature of current e-commerce models, however the chapter will provide reasonable method to resolve this issue. The proposal in this chapter utilises a combination of infrastructure providers, authentication bodies, e-commerce sellers and tax administrations, Authentication is generally accepted as a key to generating the trust needed for e-commerce to flourish and I believe that this must extend to the tax status of participants. However only authentication would not solve the problem it has to be supported by clear and uniform product classification, such an element in the compliance system will come from international coordination and respective national tax authorities and that they will take the necessary steps to facilitate it. The central element to the proposal in the effective utilisation of technology that has created Internet and then e-commerce. As Howard Smith from Computer Sciences Corporation highlights the bottom line: *"Trade, whether conducted via the medium of the Internet or any other, is*

## INTRODUCTION

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*(very simply trade). Therefore, the taxation of it is a legal issue, not a technological one. However, if the technology makes it impossible to extract tax, society has a problem.*"<sup>4</sup> In my view the technology, will provide a solution.

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<sup>4</sup> Howard Smith, Principal Consultant at Computer Sciences Corporation as he than was.

# Chapter – 2

## GLOBALISATION AND E-COMMERCE

### INTRODUCTION

Globalisation is a description of the fact that other people, or governments, or businesses, or decision-makers all around the world affect countries and their citizens. In addition, because communication is faster, and transport cheaper, the connections are immediate and more intense than ever before. It was technology, which fuelled globalisation and now it is the globalisation that gave impetus and demand to new, better, faster technologies. Alongside the economic drive for globalisation is the unleashing of the potential of information technology.

## 2.1 GLOBALISATION

### 2.1.1 MAKING SENSE OF GLOBALISATION

Is globalisation a new phenomenon? The processes that is described as 'globalisation' – the accumulating consequences of 'the annihilation of distance', i.e. the improvement in techniques of, and the rapidly reducing costs of, transportation and communication-have been at work without significant interruption since the improvement in navigation five centuries ago. Already in the mid-nineteenth century, visionary writers were looking forward to "*a single, more or less standardised world where all governments would acknowledge the truths of political economy and liberalism would be carried throughout the globe.*" (Hobsbawm, 1977)

What then is distinct about globalisation? It is argued by some scholars that globalisation is not a value that; it is a process that describes what is happening. Scholte (1997) defined it as a process whereby social relations acquire relatively distance less and borderless qualities so that human lives are increasingly played out in the world as a single place<sup>1</sup>. What happens on the New York Stock Exchange can influence what happens on the London or Australian Stock Exchange and if it does, it can affect the net worth of the millions of British people who, for example, own 'Marconi' shares.

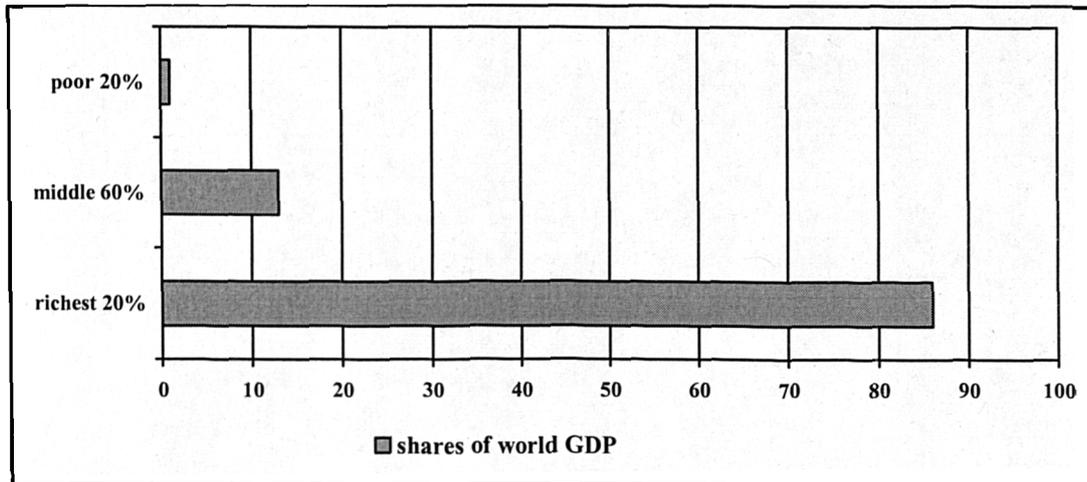
However, why the wave of globalisation has progressed? In the last decades of the 20<sup>th</sup> Century, leading industrial nations increased their spending on research and development, which determined the pace of technological change. There was also a shift in perceptions about the appropriate role of the government and a broad global consensus on the need for market-friendly policies as a means of rapid and sustained economic growth. Further the push by the various international institutions towards global economic liberalisation (i.e., reduced policy barriers to trade and investment) - the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO) in the case of world trade in goods and services, and the International Monetary Fund (IMF) in the case of global finance and capital flows.

While so much has been made of globalisation, what does the evidence show about the extent to which globalisation has benefited the under developed and developing countries? Economists do not have clear-cut answers as to the impact of globalisation, but confirm that its impact varies according to the characteristics of the countries and the segments of the population concerned (Lecomte, 2002). Nevertheless, it is difficult to exclude any country or region from the effects of globalisation. Even very poor and under developed countries that do not have electricity, let alone any aspiration to be wired to the Internet are gradually being integrated into the world global society. There are many events in the

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<sup>1</sup> Scholte, Jan Aart (1997)

world that can affect these isolated countries. For example, multi-national corporations can exploit them for cheap labour; they can be the recipients of aid through the efforts of non-governmental organisations, and they can suffer the effects of environmental degradation. Halliday has argued that the world is becoming an increasingly unequal place in terms of income, life opportunities, and technological change (Halliday, 2000). The gap in terms of income is striking. As the UN Development Programme has emphasised in its recent reports, the gap between the richest and the poorest 20 percent of the world has increased to 86:1 and it widens every day (Fig: 2.1).



**Figure 2.1: Shares of World GDP**

An examination of the 'UN World Investment Report' showed that foreign direct investment has increased from approximately \$300 billion or \$400 billion a year in the early 1990s to almost \$900 billion in the year 2000. However, 80% of that goes to OECD countries, and over 50% of the remaining 20%, which goes to emerging markets, or Third World countries, goes to just 10 countries. International trade is growing with more than 6% pa. The OECD countries, whose inhabitants are 19% of the world's population, have 71% of global trade. The least developed countries have only a little more than 1%.<sup>2</sup> In other words, by all practical measures, there are well over 100 countries in the world, which are excluded from the global flow of investment. Thus, there is income and investment inequality (Halliday, 2000).

Hence, the challenge of globalisation is not to stop the expansion of global markets but to find the rules and institutions for stronger governance of local, national, regional and global to preserve the advantages of global markets and competition, but also to provide enough space for human, community and environmental resources to ensure that globalisation works for people not just for profits. According to Gilley:

*"Many more people have access to the same technology, finance and information than ever before. That means we are all competing in life, love and work with*

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<sup>2</sup> Globalisation - advantages and disadvantages  
Website: <http://www.istoselides.gr/world/article.php?sid=84>

*everyone else in the world, a true human race. In addition, since those things are not likely to change, the forces of globalisation are irreversible.*<sup>3</sup>

### 2.1.2 CHALLENGES OF GLOBALISATION ON TAXATION

The globalisation of commercial activity has progressed much faster than the creation of international regulatory frameworks to govern this activity. Commentators disagree over just how much global economy should be regulated, but most acknowledge that existing rules governing tax systems, and particularly international taxation arrangements, can struggle to keep pace with globalisation and market liberalisation. Most of today's tax arrangements were developed in an era when tax authorities could rely upon exchange controls highly regulated capital markets and technological constraints to protect them from the negative fiscal effects of global activities. These barriers to cross-border activities protected tax authorities from the full implications of the interaction between national tax systems. While corporations globalise, tax authorities remained constrained by national frontiers.

Not unconnected with the above, globalisation also lead to preferential tax treatment for mobile factors relative to immobile ones as it increases the mobility of high earners. As the importance of multinational companies grows, so do the opportunities for their workers to move from country to country. Increasingly, multinationals operate in developing economies, which have low taxes, or are willing to negotiate a favourable tax regime to attract business. Indeed, at the extreme, complete factor mobility of these MNC may imply that taxes fall solely on the immobile ones, as mobile factors can relocate to overseas (Asher and Rajan,1999). According to Oxfam, tax competition, and the implied threat of relocation, has forced developing countries to progressively lower corporate tax rates on foreign investors. Ten years ago, these rates were typically in the range of 30-35% - broadly equivalent to the prevailing rate in most member countries of the OECD. Today, few developing countries apply corporate tax rates in excess of 20%. 'If developing countries were applying OECD corporate tax rates,' the report says, 'their revenues would be at least \$50 billion higher'.<sup>4</sup>

The general conclusion is that, given the need to maintain a certain amount of public spending, particularly in open economies, globalisation may lead to reduced progressivity (increased inequity) of tax structures. Thus, taxes levied directly on relatively immobile factors would be welfare-enhancing in the sense of having the same incidence as taxes on the mobile factors, without necessarily leading to the flight of the latter in an attempt to *evade/avoid* the burden of the tax. Given the increased mobility of various components of the tax base, this in turn implies intensified dependence on a narrow part of

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<sup>3</sup> This conclusion is reached by Bruce Gilley in his review of the book, *The Lexus and the Olive Tree*, by Thomas Friedman for the Far Eastern Economic Review. Available online at [http://203.105.48.72/9907\\_15/p35inreview.html](http://203.105.48.72/9907_15/p35inreview.html)

<sup>4</sup> Financing Social Development: Progressive Taxation and Globalisation Prepared by *United Nations Non-Governmental Liaison Service (NGLS) July 2000*  
<http://attac.org/fra/orga/doc/ngls.htm>, Last accessed August 2002.

the tax base consisting of immobile factors such as the less educated workforce and the rural sector. However, there are several other questions. How can fair tax competition flourish between sovereign nations, but unfair competition be eliminated? Does the 'new economy' imply new taxes or a need to re-design old ones? Moreover, what is the role of tax administrations in this new world: are they just the collectors of tax or the facilitators of a wide range of government services? The OECD among few others has accepted the challenges of the new global environment and its partnership programme now extends to more than 70 countries beyond the OECD area, which are looking for answers to those questions. I would re-visit these questions in this thesis but from the e-commerce and consumption taxation point of view.

2.2 DEVELOPMENT OF INTERNET

2.2.1 INTERNET

Interaction between people from different societies is today best personified by the Internet - a tool that allowed many more people to influence and be influenced by countless other individuals. The 'instantaneous' nature of interaction due to Internet best characterises globalisation today. It transcends national borders and engenders a supra-territorial effect (Fig: 2.2).<sup>5</sup>

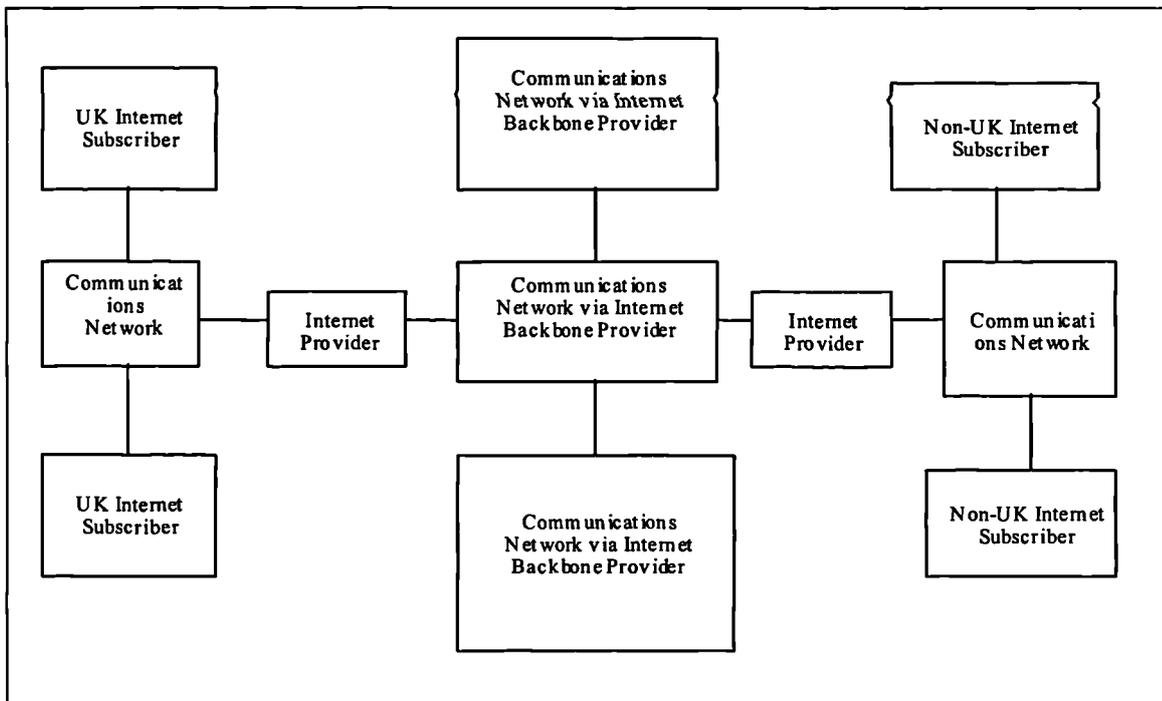


Figure 2.2: How the Internet Works

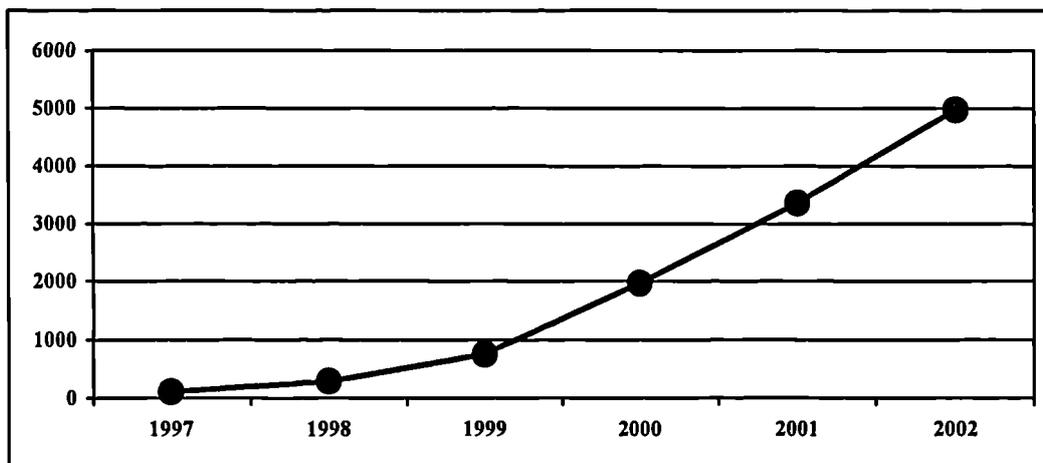
<sup>5</sup> Scholte (1997) at p 15.

The first computer network, known as APANET was conceived by the United States Department of Defence and was created in 1969 with four nodes. The word Internet was defined in a 1995 resolution of the United States' Federal Networking Council as follows: Internet refers to global information system that

- is logically linked together by globally unique address space based on the Internet Protocol (IP).
- is able to support communications using the Transmission Control Protocol/Internet Protocol suite.
- provides, uses or makes accessible, either publicly or privately, high level services layered on the communications and related infrastructure described herein.

In 1991 for the first time the National Science Foundation (NSF) that funded the Internet infrastructure in the United States relaxed its ban on the commercial applications. The most significant technical innovation that followed was undoubtedly the introduction of the World Wide Web (WWW) in 1992. In essence, the development of WWW is a triumph of form over function. It was Tim Berners-Lee of the European Particle Physics Laboratory (known as CERN, a collective of European high-energy physics researchers) who used a system known as hypertext to create links between files. By the end of 1990, the first piece of Web software was developed with the ability to view, edit, and send hypertext documents to colleagues via the Internet. The Web was born.

The advent of browsers such as Netscape Navigator and Microsoft Internet Explorer served as the complete transformation of the Internet from a text-based network to what has been described as a *'multimedia tapestry of full-colour information.'*<sup>6</sup> Business, sensing the opportunity, began a mad rush to establish a 'presence' on the Web. The Web soon became the dominant service, with the exception of email, on the Internet.<sup>7</sup> Internet is growing at the rate of 10 to 15% per month. Figures 2.3, 2.4, and 2.5 below give an idea about this phenomenal growth of Internet.



6 International Telecommunications Union, Challenges to the Network: Internet for Development, Feb 1999

7 Source [www.nua.com/surveys/how\\_many\\_online/index.html](http://www.nua.com/surveys/how_many_online/index.html)

Figure 2.3: Growth of Internet Access (source Forrester)

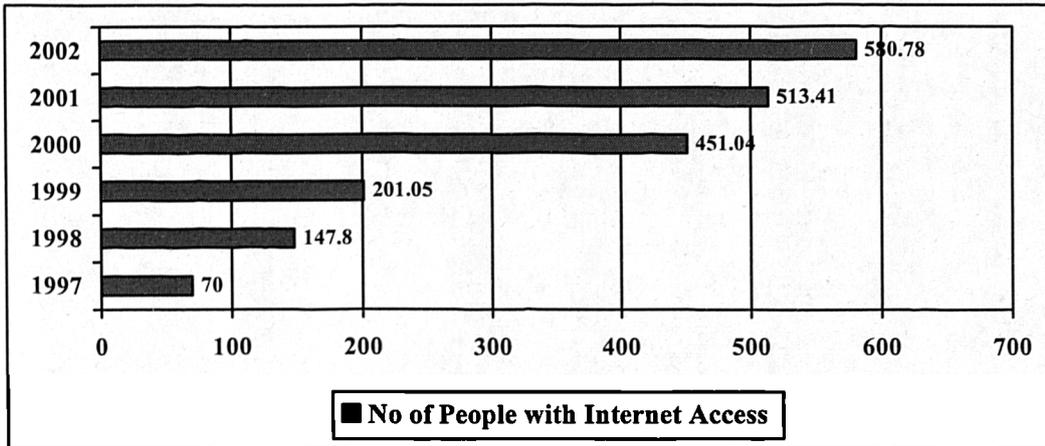


Figure 2.4: No of People with Internet Access (Source: Forrester)

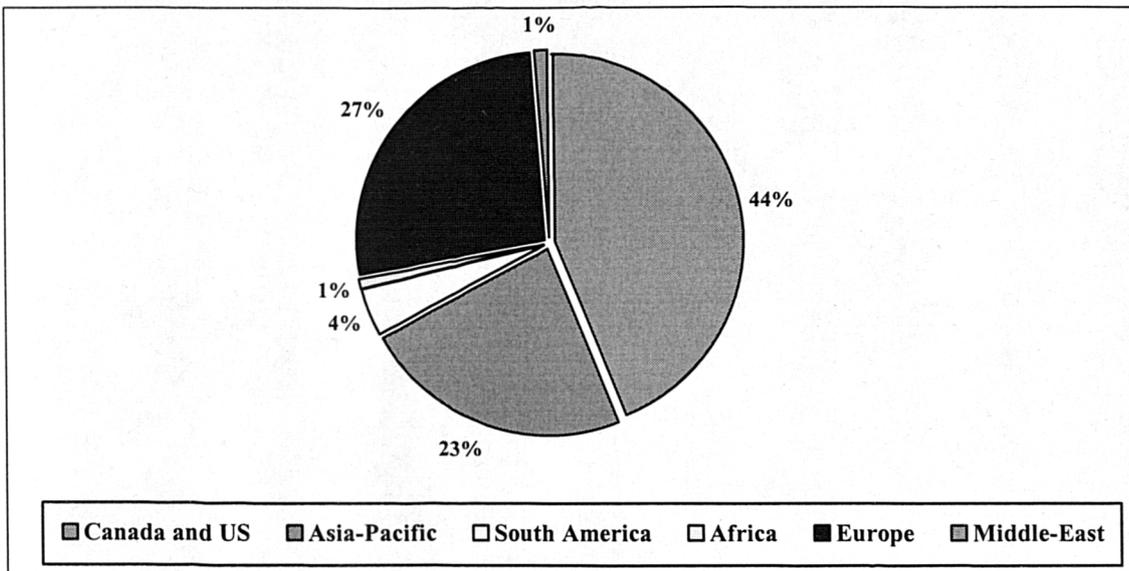


Figure 2.5: Internet Users by Region

2.2.2 INTERNET SERVICE PROVIDER (ISP)

As the technology stands today, a access to the Internet is achieved through the assignment of a IP address, which in simple terms would direct the computer to a signal source connected to other computers. A person by dialling would call the server of another computer which would then be able to route the call to other Internet nodes until finally the signal from the home computer would be directed to (but also from) a remote computer anywhere else in the world. This network of nodes was what gave the Internet its reputation of being a worldwide web connecting millions of computers to each other. The inevitable first 'port of call' for a person to connect to the Internet is through the servers of an

Internet Service Provider (ISP). ISP provides 'access to global information networks.' An ISP would give a private user an IP-address to call to gain access to the web. The access services provided by ISPs could be regarded as the other side of the coin of e-commerce, since companies would be unable to sell their products if nobody was able to connect through to their servers. ISPs may be grouped in three basic categories: (i) backbone providers; (ii) regional providers; and (iii) local providers.<sup>8</sup>

The best example of a backbone provider is a telecommunication company that in addition to providing physical infrastructure for the Internet with its cables and wires (thus allowing the physical connection among network users) also provides the logical infrastructure that makes it possible for customers to transmit and receive information on that physical network. It is not necessary, however, to hire a backbone provider in order to be connected to the Internet. Regional networks can provide the link between local organizations and the backbone providers. While a regional network operates within a limited geographic area, data sent over a regional network could still reach any computer anywhere in the world that would be connected to the Internet. This could occur because the regional network had purchased services offered by a backbone provider (i.e., by interconnecting with one or more backbone providers at one or more central locations) so that information could flow from the regional network to the backbone provider and then from the backbone provider perhaps to another regional carrier across the world that would be the ISP for the intended recipient. Local ISPs provide Internet access within a city or limited geographical area. A local ISP subleases circuits from national or regional ISPs, adding its own support and application services. When a company decides to maintain its web site, it has to contact an ISP to establish a connection to the Internet. The company may choose to maintain its web site on its own server or on the server of the ISP. Once the company has set up a server with an Internet protocol address (IP), its web site can be accessed by customers through any ISP. All the customers have to do is type the address of the enterprise (e.g., <http://www.acorp.com>).

Suppose a country 'A' resident, A Corp., is a retailer selling a wide variety of goods and services. A Corp. is contemplating entering the market for country B customers. A Corp. plans to have no offices, warehouses, factories, or other facilities in country B. No employees of A Corp. would work in country B. However, residents of country B would be able to purchase goods from A Corp. by logging on to A Corp.'s Web site on the Internet. To establish an Internet presence, A Corp. arranges with an ISP ('Just connect Corp.') to establish a connection to the Internet. A Corp. might maintain its Web site on its own server or arrange for space on a server maintained by 'Just connect Corp.' or by a third party that has arranged with an ISP. A Corp. might arrange to locate the Web server in country A, in country B, or in any other country, or the server could regularly be moved from jurisdiction to jurisdiction. Once A Corp. had set up a server with an Internet protocol (IP) address, A Corp. customers may choose any ISP because all ISPs would provide access to all IP addresses on the Internet. Having gained access, the

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<sup>8</sup> Abrams, and Doernberg (1997) at p 1583

customers would be free to select A Corp.'s Internet address (e.g., <http://www.acorp.com>), thereby accessing A Corp.'s Web site.

In order to surf the Internet a user would use a Web browser such as Netscape Communication's Navigator, Microsoft Internet Explorer. Once the browser is opened and when a user would enter an Internet address, a four-part process begins: connection, request, response, and disconnection. It would start with the Web browser reading the address entered by the user and would try to establish a connection with the web site through a specific server. Once the connection is established a user could request the server to retrieve some information that would be displayed to the user or to accept information such as add a customer's mailing address to the server's database. Once the connection is made and the user's request for an action had been transmitted to the server, the browser would wait for a response. After the response had been sent, the server normally disconnects from the client and the document requested and displayed to the client would temporarily be stored in the random access memory (RAM) of the user's computer. The document would not be stored in any permanent fashion on the hard drive of the user's computer unless the user would decide to do so. When the user turns off his computer, the document would be lost unless he has saved the document.

An interesting characteristic of the Internet is that the server could easily be moved from place to place. There is no central control since the nature of the system is such that it has no physical location. Users of the Internet have no control and in general, no idea of the path travelled by the information they seek or publish. In practice, it makes no difference whether the information or digital token sought to be transmitted are within one jurisdiction or between several, as the Internet pays little or no regard to national boundaries.<sup>9</sup>

## **2.3 E-COMMERCE: DOING BUSINESS OVER INTERNET**

### **2.3.1 DEFINITION OF E-COMMERCE**

In November 1999, the United Kingdom government issued *Electronic commerce: The UK's Taxation Agenda*. This document defined e-commerce in the following terms (Para 1.3):

*"While there is no internationally accepted definition of e-commerce, the Department of Trade and Industry have proposed this working definition to the OECD: '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.'"*

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<sup>9</sup> Owens (1997) at p 1837

Definitions for e-commerce vary considerably. However, consideration of two brief definitions raises some basic issues. Thus it has been said that:

*“Electronic commerce is a broad concept that covers any commercial transaction that is effected via electronic means and would include such means as facsimile, telex, EDI, Internet and telephone. For the purposes of this report the term is limited to those trade and commercial transactions involving computer-to-computer communications whether utilising an open or closed network.”*<sup>10</sup>

In addition, it has also been said that:

*“Electronic commerce could be said to comprise commercial transactions, whether between private individuals or commercial entities, which take place in or over electronic networks. The matters dealt with in the transactions could be intangibles, data products, or tangible goods. The only important factor is that the communication transactions take place over an electronic medium.”*

One of the best ways of understanding e-commerce is to consider the elements of its infrastructure as the above two definitions suggest, e-commerce as it has evolved today requires three types of infrastructure:

- *Technological infrastructure to create an Internet marketplace:* E-commerce relies on a variety of technologies, the development of which is proceeding at breakneck speeds (e.g., interconnectivity among telecommunications, cable, satellite, or other Internet ‘backbone;’ Internet service providers (ISPs) to connect market participants to that backbone; and end-user devices such as PCs, TVs, or mobile telephones).
- *Process infrastructure to connect the Internet marketplace to the traditional marketplace:* This infrastructure makes payment over the Internet possible (through credit, debit, or smart cards, or through online currencies). It also makes possible the distribution and delivery (whether online or physical) of those products purchased over the Internet to the consumer.
- *‘Infrastructure’ of protocols, laws, and regulations:* This infrastructure affects the conduct of those businesses engaging in and influenced by e-commerce, as well as the relationships between businesses, consumers, and government. Examples include technical communications and interconnectivity standards; the legality and modality of digital signatures, certification, and encryption; and disclosure, privacy, and content regulations (Mann, 2000).

### 2.3.2 BENEFITS OF E-COMMERCE

While borders still matter in the world of international trade, e-commerce diminishes their importance. It has integrated the domestic and global markets from very inception. No longer do customers need to be physically present to see or hear what they are buying. As a result, companies on the Internet instantly become international: ‘Amazon.com’ was selling books to customers in over 40 countries in

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<sup>10</sup> Report of the Electronic expert Group to the Attorney General (Australia), Electronic Commerce: Building the Legal Framework, 1998, available at [www.law.gov.au/aghome/advisory/ecag/single.htm](http://www.law.gov.au/aghome/advisory/ecag/single.htm)

its first *month* of existence; the company now sells a variety of products to customers in over 160 countries.

Further e-commerce encompasses a broad range of activities. The core component is addressing the commercial transaction cycle. It also includes the advertising and promotion of products and services, the facilitation of contacts between traders, the provision of market intelligence, pre- and post-sales support, electronic procurement and support for shared business processes, together with this e-commerce had also innovated the traditional marketplace in three ways:

- *Process innovations:* E-commerce simplifies, makes more efficient, reduces costs, or otherwise alters the process by which an existing transaction takes place. For example, Cisco Systems replaced its phone, fax ordering process with an online ordering process, saved more than one-half billion dollars, and reduced error rates from 25% to 2%.<sup>11</sup> Boeing used computer-aided design and electronic communication to coordinate 238 design teams in the globalise production of the 777 aircraft, a process never before attempted in this way, and which cut error rates by 50%, and reduced both costs and time to market<sup>12</sup>. Internet has given birth to corporate '*supply chains and markets that facilitate buying and selling*'. A corporate extranet is approximately 10 times less expensive than the electronic data interchange (EDI) and is interoperable. It offers media-rich marketing and customer feedback, services traditionally unavailable through the EDI (Mann, Eckert and Knight, 2000)<sup>13</sup>. 'Dell' was able to spot its suppliers on the Net and customize its products. It keeps components for 8 days. 'Dell' manufactures a computer after the customer had specified the type of processor, memory capacity, hard disk space, and the type of screen. The US toy maker 'Mattel' allows customers to design their perfect 'Barbie doll'. Norwegian bicycle maker 'DBS Oegland' allows customers to design their own version of the Intruder (Cairncross, 2001)<sup>14</sup>. The Internet enables the recording of precise specifications, and, allows the concerned corporation to deal with a larger number of suppliers. GE Lighting has cut down costs by 20%. 12 large US companies pooled their buying power to create a single purchasing consortium for requirements ranging from energy, to advertising and marketing. GM, Ford, and Daimler-Chrysler have established 'Covisint' to handle auto parts transactions from suppliers, a supply chain worth \$ 250 billion (Cairncross, 2001; Fine and Raff, 2001)<sup>15</sup>.
- *Product innovations:* E-commerce creates or facilitates new industries and products not previously available. For example, MP3 both enables consumers to play music downloaded from a computer and enables musicians to upload music directly to the

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11 For more elaborate discussion of definitions, see [www.oecd.org/dsti/sti/it/ec/act/SACHER.HTM](http://www.oecd.org/dsti/sti/it/ec/act/SACHER.HTM) at pp 60-61 in *The Economic and Social Impact of Electronic Commerce*, OECD, 1999.

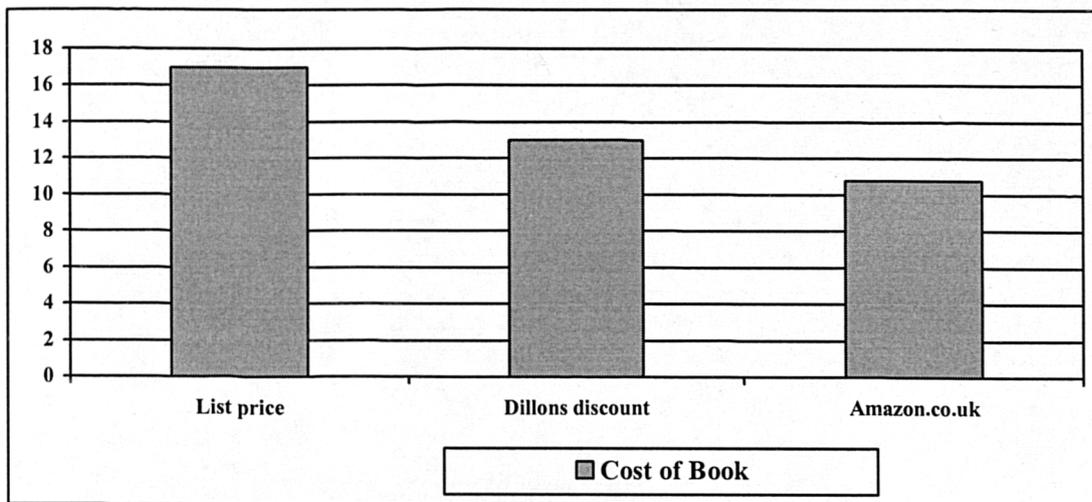
12 [www.boeing.com/news/1995/news.release.950614-a.html](http://www.boeing.com/news/1995/news.release.950614-a.html) last accessed June 2000.

13 Mann, Eckert and Knight (2000) at pp 9-10

14 Cairncross (2001) at pp 122, 142-143

internet, thereby creating a new medium to produce and consume music; WebMD repackages existing health information in an easy-to-use online format, offers opportunities to ‘chat’ with people with similar health concerns, and provides ‘real-time’ responses to health questions.

- *Market innovations:* E-commerce also creates new markets in time, space, and in information that never before existed because; transaction and co-ordination costs were prohibitively high. For example, the online bank *FirstDirect* offers 24-hour bill payment features; *PeopleLink* is a global advertising location for artisans in remote parts of Latin America and Africa; reverse auctions through *Priceline* inform businesses of the exact price a consumer is willing to pay for the products, as well as reduce the consumer’s purchase cost. There are virtual *auction sites* for products ranging from steel, advertising space, transportation services, and computer services, skilled labour services, to consumer goods. *Virtual brokers* provide referral services that resemble yellow page directories with comprehensive information and search facility<sup>16</sup>. *E-exchanges* provide services like trading rules, price transparency, and centralized clearing<sup>17</sup>. Some virtual markets do not fit into these neat definitions. *PlasticsNet* runs auctions for some transactions and broker functions for other products (Cairncross, 2001, Lucking-Reiley and Spulber, 2001)<sup>18</sup> (Fig 2.6).



**Figure 2.6: E-Commerce Reduces Prices for the connected consumer,**  
**Source: Dillons; Amazon.co.uk. The cost book in case of amazon.co.uk includes the cost of distribution**

Hence e-commerce could be divided into three stages: *first*, the pre-purchase stage including advertising and information seeking; *second*, the purchase stage, including purchase and payment; and *third*, the delivery stage. In principle, all types of products could be advertised and purchased over

15 Ibid at pp 137-140; Fine and Raff (2001) at p 74

16 Examples include, catalogues for office supplies (Iprocure), industrial chemicals (E-chemicals), construction (Buzzsaw) and bakery supplies (Bakery Online).

17 Examples include exchanges in, almonds (AlmondEx), oil and gas (Altra Energy), telecommunications bandwidth (Arbinet), chemicals (CheMatch), steel (e-steel), and paper (PaperExchange)

18 Lucking-Reiley and Spulber (2001) at pp 55-68

electronic networks. The potential for electronic delivery, however, would be more limited. It would require that a final product could be presented as digitalized information and transmitted electronically. Many services could be supplied as digitalised information, including financial transactions or legal advice. Some information and entertainment products typically characterized as goods, such as books, software, music and videos embody digitalised information that could also be supplied electronically over the Internet. All three aspects or stages of e-commerce defined here may have certain tax policy implications, but for the purpose of this thesis more emphasis shall be placed upon the electronic supply of final products, or in other words, on the third stage.

### **2.3.3 TYPES OF E-COMMERCE**

#### **A. Business-business E-Commerce**

Business-to-Business (B2B) e-commerce encompasses the entire commerce cycle, from awareness to product research, comparison, selection, supplier-sourcing, negotiation, trade documentation, payment, logistics, and post-sales support, basically this kind of e-commerce refers to a company selling or buying from other companies.

#### **B. Business-consumer E-Commerce**

The business-to-consumer e-commerce refers to a company selling its products or services to the customers and largely equates to electronic retailing. The e-commerce has a unique way of facilitating *customer relationship management* (CRM). There is some business that relies solely on the virtual shop front as they do not have a physical store for walk-in customers (example, Internet booksellers Amazon.com). On the website, the company can put up information about products and services, allow customers to order these from the website and provide customer support services. In order to get customers to the website, the company must inform the public about its existence using traditional means of advertising (commercials, adverts, brochures, etc) and/or online advertising. To keep customers returning to the site, the company must also update it regularly with news about products or promotions. This increases the accuracy of Amazon's future recommendations to the same person (Cairncross, 2001). Aided by customer data, information products can be sold in various versions, each targeted to a specific customer (Bakos, 2001)<sup>19</sup>. Although many companies using e-commerce have done away with the need for traditional intermediary, however this has also caused the rise of the new digital intermediary. These digital intermediaries have slightly different roles than their traditional counterparts. The digital intermediary in e-commerce could be a company that creates a virtual community or portal on the Internet and then gathers several companies together into this community. The intermediary then promotes this new virtual community to the public. Some of these communities are service or product specific, meaning that all the companies in the community provide only a specific type of service (e.g. travel) or product (e.g. cars) to the visitors.

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<sup>19</sup> Bakos (2001) at pp 70-80

**C. Business-administration E-Commerce**

The business-administration category covers all transactions between companies and government organisations, helps both the government and businesses to reduce costs, and improves efficiency. For example, in the USA, the details of forthcoming government procurements are publicised over the Internet and companies can respond electronically. In addition to public procurement, administrations may also offer the option of electronic interchange for such transactions as VAT returns and the payment of corporate taxes.

**D. Consumer-administration E-Commerce**

The consumer-administration category has not yet emerged. However, in the wake of a growth of both the business-consumer and business administration categories, governments may extend electronic interaction to such areas as welfare payments and self-assessed tax returns. Such transactions have already started in Singapore where citizens can file tax returns electronically.

**2.3.4 DIRECT AND INDIRECT E-COMMERCE**

To identify the specific fields of online trade where the conventional Sales tax and VAT model proves to be dysfunctional a distinction should be made between the different types of e-commerce transactions. Based on the extent to which the Internet is utilized in the course of a transaction e-commerce can be 'indirect e-commerce' and 'direct e-commerce'. Indirect e-commerce involves transaction where the customers use the selection, ordering and payment process (electronic cash) of the retail stores or the mail order firms who use this medium for selling, marketing, and advertising, but the delivery of product or service takes place by traditional process.<sup>20</sup> The goods and services, in digitised form, acquired directly from Internet, is referred to as 'direct e-commerce'.

The 'Direct e-commerce' would have most impact on two types of products. *First*, a number of products, which traditionally have been delivered as 'goods,' can now be sent across network in digital form. *Second*, it would strongly affect trade in services<sup>21</sup>. World trade in these products amounted to about US\$ 44 billion in 1996, or less than 1% of total world trade but printed matter and recorded tapes, CDs, packaged software, etc. account for 60% of the total. While the overall numbers are relatively small, trade in several products has increased rapidly in recent years. Average annual trade growth for digitizable media products was about 10% between 1990 and 1996, 1.5 times as fast as total world merchandise trade. Trade growth in recorded media such as CDs and packaged software was still

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20 EC Commission, Communication A European Initiative in electronic Commerce, Com (97) 157: "indirect electronic commerce- the electronic ordering of tangible goods, which must be physically delivered using traditional channels such as postal services or commercial couriers; and direct electronic commerce- the online ordering, payment and delivery of intangible goods and services such as computer software, entertainment content or information services on a global scale.

higher, at an average annual growth rate of almost 17%. The EU (including intra-EU trade) accounts for 45% of world imports or about US\$ 20 billion. For most countries, imports of digitizable media products account less than 2% of total trade.

These figures, though show that trade in digitizable media products is currently not very large. However, this would eventually change to some extent in the near future with Internet access would become more widely available and making the downloading of information faster. The increasing access to the Internet is likely to result in stagnation, and possibly an eventual decline, in physical trade in these products due to their substitution by trade in electronic form. In sum, above average growth rates of physical trade in these areas would likely to continue in the near future, even though eventually they would stagnate and even decline due to the increasing electronic trade of such products. If physical trade continued to grow at 10%, it would reach US\$ 100 billion in 8 years. If the growth rate accelerated to 15%, such trade would triple to US\$ 150 billion over the same period. It is this borderless world of the direct e-commerce, which is posing the more threat to the preservation of tax base (Pérez-Esteve and Schuknecht, 1999).

#### **2.4 GROWTH OF GLOBAL E-COMMERCE**

Internet and e-commerce are growing so fast that forecasters regularly underestimate how many users would be online and how much revenue would be generated by e-commerce. Metcalf's law states that the utility of a network increases exponentially as each new user joins. It is relatively simple concept that has been known since the first humans joined into a community. Some of the greatest benefits of belonging to a group arise as a direct result of just belonging to that group. If millions of computers are connected together into a network, all of a sudden a utility is created. It establishes a standard simply because of the volume of the users. This concept is known as 'critical mass' and it is what companies are trying to achieve when they start on online business or migrate their existing business over to the world of e-commerce.

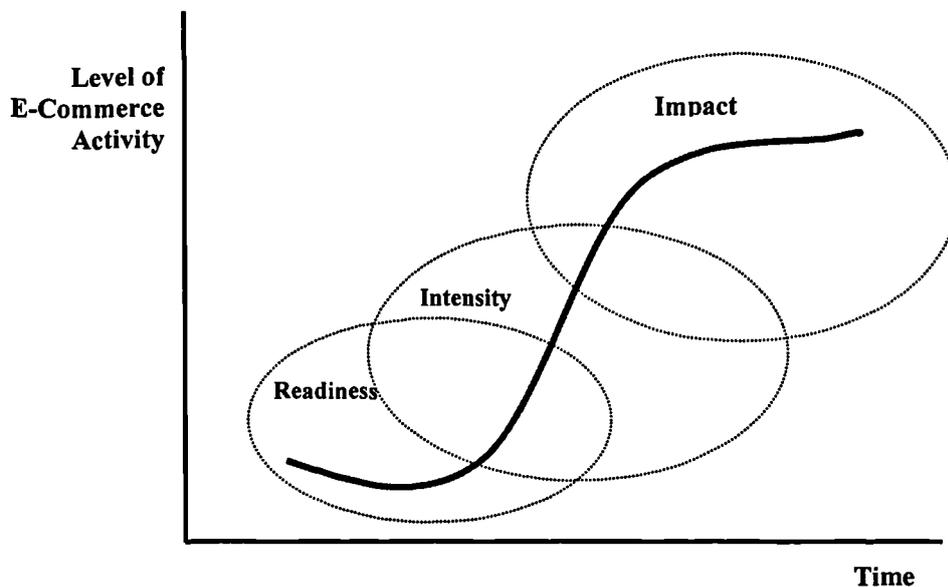
To measure the growth of e-commerce each country or economy would first want to reflect on what kind of e-commerce data they want to measure, depending on the stage of development their country has achieved in the area of e-commerce. Some countries (in particular, developing countries) may be at an early stage, while others may already be very active users of e-commerce and the Internet. A good model for identifying these needs of e-commerce data users has been proposed by Canada and is generally considered as a good starting point for statistical work on e-commerce (Fig: 2.7).

The chart illustrates that a distinction needs to be drawn between situations where a country might wish to know about:

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21 The former category of products is basically software and media products, and includes film, various types of printed material, video games and various recorded information on carrier media

- the readiness of its people, businesses, infrastructure and its economy generally to undertake e-commerce activities this is likely to be of interest to countries in the early stages of e-commerce maturity or activity,
- the intensity with which information and communication technologies are utilised within a country and the extent that electronic commerce activities are undertaken – this is likely to be of interest to countries where e-commerce is becoming much more prevalent, and
- the impact of e-commerce on national economies and business activities being carried out in those countries – this is likely to be of interest in countries where e-commerce activities are very well developed.



**Figure 2.7: S-Curve: Level of E-Commerce activity**  
Source: Industry Canada, presented at the OECD Workshop on Defining and Measuring E-commerce (April 1999)<sup>22</sup>

As shown, there is a fair degree of overlap between the various stages of maturity of e-commerce and the growth of e-commerce.

Forrester Research, Inc. USA, a leading consultancy firm in e-commerce forecasted that worldwide e-commerce would reach \$6.8 trillion in 2004. This growth would happen as the world's largest economies come online by 2004 and it expected worldwide e-commerce revenues to surpass \$300 billion by 2002 and would accelerate to \$1.3 trillion in 2003. It is projected that by 2005, e-commerce in US alone could surpass the \$6 trillion mark (Jupiter Communications, 27 June 2000). This figure is far the larger than any forecast for these same years published in OECD study in 1997, which ranged from \$10 billion to \$1.5 trillion (OECD 1999, 27). Currently an overwhelming (close to 85%) share of

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such as tapes, CDs, CD-ROMs and diskettes  
22 Susanne Teltscher (2001) Measuring Electronic Commerce in Developing Countries, UNCTAD's *Electronic Commerce and Development* Report 2001

e-commerce is concentrated in the US, but diffusion into Europe and Asia, followed by Latin America and Africa would be rapid. In developing countries Internet, use and its economic potential are growing exponentially. The share of active Internet users in Asia/Pacific Rim, Latin America, and 'rest of world' could increase from 23% in 1999 to 35% in 2002. In China, for example, e-commerce revenues are expected to grow from \$11.7 million in 1998 to \$1.9 billion in 2002 (ITU, 1999, 47)<sup>23</sup> (Fig 2.8).

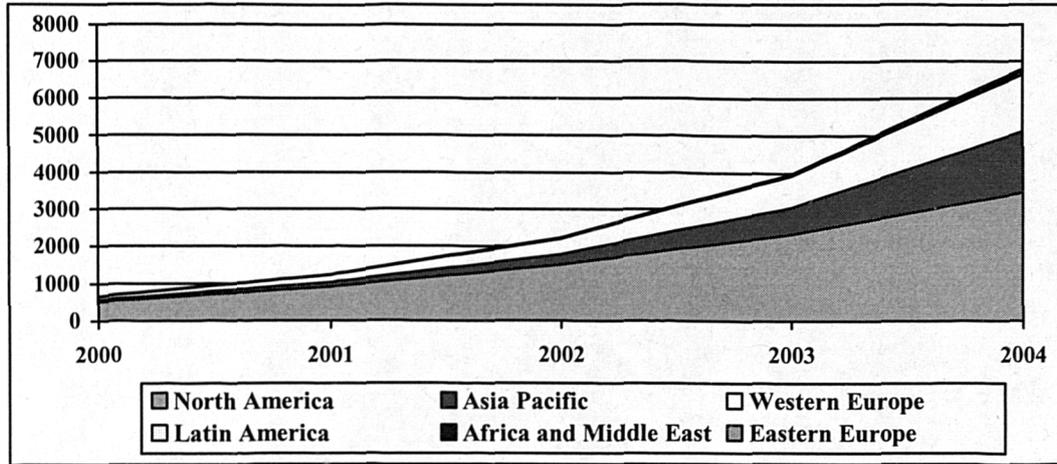


Figure 2.8: Growth of E-commerce by Region

Studies that separate out e-commerce from rest of the IT sector illustrate while still a very small percentage of total revenue, e-commerce is growing quickly. According to Forrester Research, B2B e-commerce is projected to reach over \$1.3 trillion by 2003, comprising over 9% of the U.S. GDP (Fig 2.9).

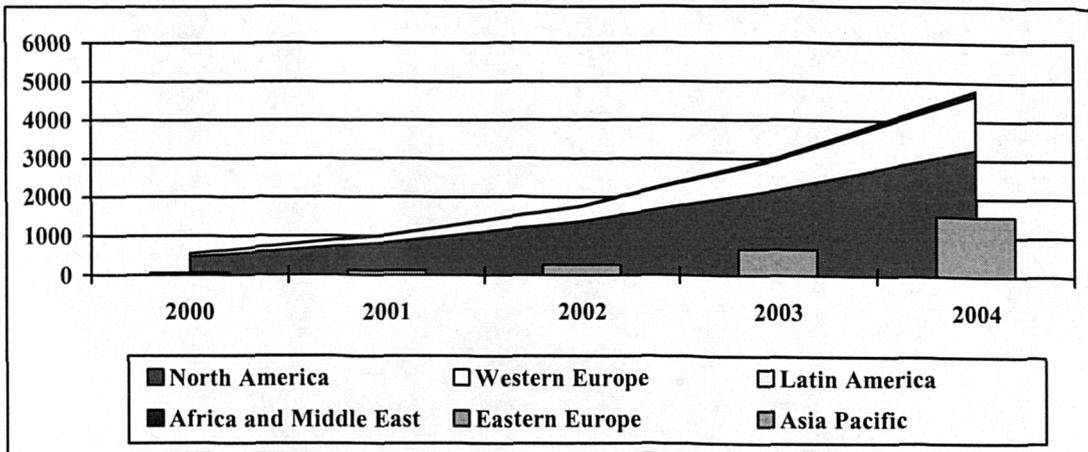


Figure 2.9: Global B2B E-Commerce (US \$ Billion)

Datamonitor predicts that Western European spending on business-to-business e-commerce solutions and on services (consultancy, systems integration) will grow most rapidly, experiencing a 92% compound annual growth rate over the period 1997 – 2002, compared to 66% for hardware and 85% for software. European B2B e-commerce is projected to grow over 2400 percent from \$7.15 billion in

23 International Telecommunication Union, Challenges to the Network: Internet for Development, October 1999 (updated), at 47, using data from International Data Corp.

1998 to \$176 billion by 2003. Datamonitor has also produced forecasts for the business-to-consumer market: it predicted that total revenues from online shopping at European sites would grow from \$111m in 1997 to nearly \$5 billion in 2002. It predicted that travel products would experience greatest growth, from 7% to 35% of the total online product mix over the period 1997-2002 (Fig: 2.10).

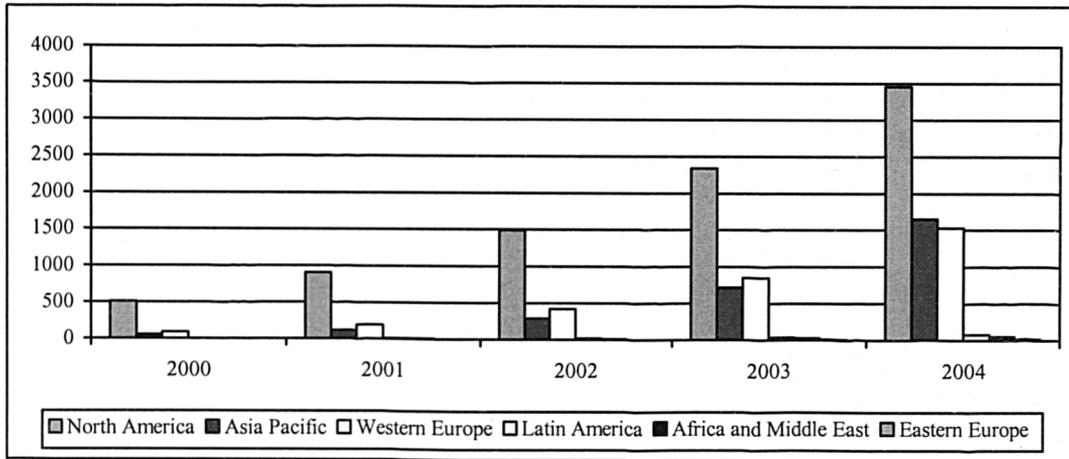


Figure 2.10: Global B2C E-Commerce

Cross-border service trade involving communications services, computer and information services, and other business services conducted over telecommunications networks at \$ 375 billion in 1999 constituted approximately 30% of service trade and 5% of world trade. Trade in digitizable media products (film, printed material, video games and recorded information) was worth about \$ 50 billion (< 1% of world trade) in 1998 (Mattoo, Perez-Estevé and Schuknecht, 2001)<sup>24</sup>.

The emerging consensus was that the dramatic rise in the annual growth of US productivity for the period between 1995-2000 (2.5% between 1995-2000, when the same figure for the period between 1974 –1995 was 1.4%) was largely due to the productivity enhancing effect of the Internet. The declining price of semiconductors and electronic devices is at the root of this revolution. Declining costs made this technology available to small as well as large corporations (Varian, Litan, Elder and Shutter, 2002)<sup>25</sup>. The Internet’s ability to transmit high-speed low cost information is transforming business at the global level.

Diffusion and usage of Internet and e-commerce-both within individual countries and between developed and developing countries is a function of a number of factors, including age, income and education. E-Commerce increases the efficiency of resource utilization, which translates into faster productivity growth, which supports higher sustain GDP. Research shows a positive relationship between, for example per capita GDP and density of Internet host (UNCTAD, 2000, at 75). Similarly, higher income per capita is associated with a higher share of those using Internet. Broader measures of development like the Human Development Index show that as human development indicators increase, Internet penetration increases even faster, suggesting important synergies, among education, life

24 Mattoo, Perez-Estevé and Schuknecht, (2001) at pp 956, 962

expectancy, income, and Internet activity (ITU 2000, 22, fig 2.2). Within country over time, it is clear even as the access increases for a country as a whole, Internet usage and simultaneously the benefit of e-commerce does not increase proportionately for all groups. For both rich and poor countries policies directed at facilitating infrastructure and basic development needs, particularly education are key to reaping the benefits of Internet and e-commerce for both countries and individual citizens. Once the infrastructure is in place the e-commerce would grow more rapidly in developing countries. America Online's (AOL) media campaign specifically targeted towards the senior citizens in USA is a good example of an existing Internet company trying to expand its consumer base. There are countless examples of these opportunities. Most of the future opportunities will be created by the companies in developing countries or will be targeted to the audiences there. E-Commerce will no longer represent only a part of a domestic business strategy or an alternative way for people to communicate. It will be integral to the economic and social fabric of the countries and commerce.

In India, according to Goldman Sach's study of Internet users, the number of users in India is expected to grow from 0.5 million in 1998 to 9 million in 2003, which translates to a compounded annual growth rate ('CAGR') of 76% - the fastest in Asia (Basu and Jones 2002). The growth of e-commerce in India between 1997 and 2003 is expected to be the highest with CAGR of 246% and e-commerce revenues could jump from \$2.8 million in 1998 to \$575 million in 2002 (Fig 2.11).

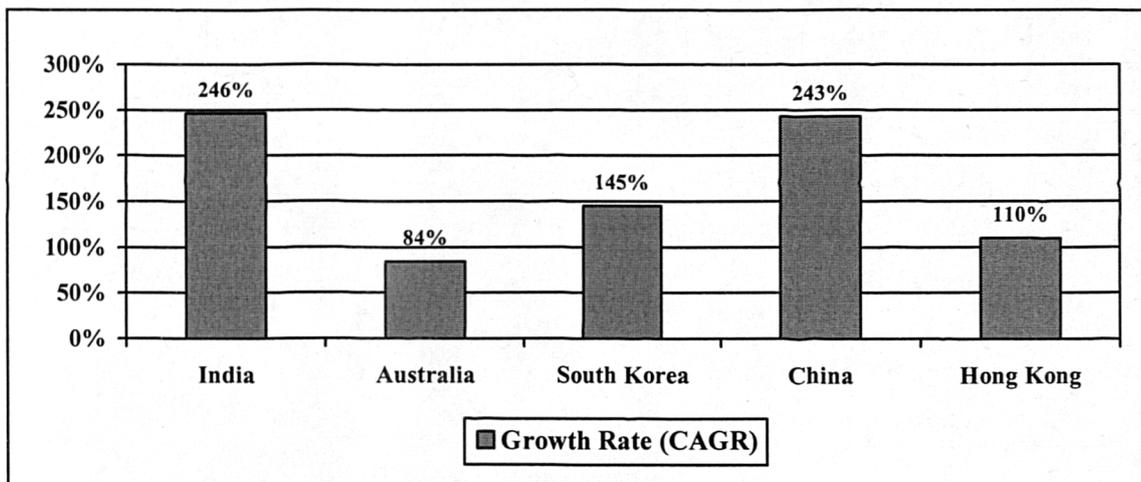


Figure 2.11: Growth of E-Commerce (by %)

In Latin America, Internet usage rose nearly eight-fold between 1995 and 1997 with revenues estimated to be \$167 million in 1998 and projected to be \$8 billion by 2003<sup>26</sup>. Internet aided business practices are significant for India's software and service exports. E-solutions involving activities like supply chain management, customer relationship management, enterprise resource planning, information management, which is expected to be 69% of IT services spending at \$ 180 billion in 2000, is an opportunity for India's software and services sector (BCG-NASSCOM, 2001)<sup>27</sup>. IT enabled services like back office accounting; medical transcription, call centres, airline ticketing, and content

25 Varian, Litan, Elder and Shutter (2002) at pp 11-14, 21-23

26 Latin Trade, March 2000, 38, Using data from International Data Corporation.

27 BCG-NASSCOM (2001) at pp 16-17

development are important service exports for India (Verma, 2002)<sup>28</sup>. Indian entrepreneurs have successfully sold Indian art, aided by the Internet. The IT sector downturn in 2000 in the US did hurt India and other IT knowledge intensive countries because of which India's software and service exports grew at an unprecedented slow pace from US \$ 4.7 billion in 2000/01 to US \$ 5.7 billion in 2001/02 (growth of 21.6%) (Desai, 2002). Worldwide revenues from supply chain management related e-solutions rose from \$ 41 billion in 2000 to \$ 62 billion in 2001 (BCG-NASSCOM, 2001)<sup>29</sup>. CRM revenues worldwide grew from \$ 44 billion to \$ 57 billion between 2000 and 2001 (NASSCOM & BCG, 2001, p. 83). *Enterprise resource planning* facilitates business functions such as accounting, human resources management (payroll), production, and distribution. 'Chem Station', a manufacturer of detergents, found that it was too expensive to ship industrial detergents. It decided to set up separate reconstitution plants with a computerized recipe to mix detergents, and electronic monitoring of the plants (Cairncross, 2001)<sup>30</sup>. *ERP related e-solutions revenues worldwide increased from \$ 23 billion in 2000 to \$ 28 billion in 2001* (BCG- NASSCOM, 2001)<sup>31</sup>. *Information Management* involves the creation, structuring, and transfer of knowledge for making the relevant knowledge available to appropriate users. According to one estimate, a building project worth about \$ 100 million generates 150, 000 separate documents. Mergers and acquisitions can create a paper trail of 30, 000 pieces of paper. London law companies Davis and Co. connect 50 lawyers, 50 accountants, and 50 due diligence specialists working in 12 cities across 9 countries through a secure Web site (Cairncross, 2001)<sup>32</sup>. With Internet content doubling every year, managing records subject to certain privacy and access specifications has become an essential service. The knowledge management portion of the e-solutions revenues has grown from \$ 2 billion in 2000 to \$ 4 billion in 2001 (BCG- NASSCOM, 2001)<sup>33</sup>. The Internet, by *facilitating speedy low cost communication renders the outsourcing of services and manufacturing easy*. E-business solutions for implementing supply chain management, customer relationship management, enterprise resource planning, information management, legacy application work, and banking software is increasingly being outsourced. Cisco Systems certified 32 plants connected with it over the Net for meeting its needs. Nortel, the manufacturer of high performance communications network, sold many of its plants to other manufacturers (Cairncross, 2001)<sup>34</sup>.

## 2.5 ELECTRONIC SIGNATURES

Maintaining consumer confidence in the virtual world will be a crucial issue for sustaining and achieving the predicted growth of e-commerce. According to GAO Report<sup>35</sup> (2002) "*if buyers find that they do not have effective consumer protections, that their personal data are not safeguarded, that their transmissions are not secure, or that shopping on line is more cumbersome than purchasing off line,*

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28 Verma (2002) at p 48

29 Supra Note 27 at p 83

30 Cairncross (2001) at p 43

31 Supra Note 27 at p 83

32 Supra note 30 at pp 133-136

33 Supra Note 27 at pp 83

34 Supra Note 30 at pp 142-143, 150-151

35 GAO (2002) at p 22

*then they may be less likely to use the Internet to make purchases*". For example, a 1998 survey found that 61% of those who had never made an on-line purchase cited concerns about credit card security as a reason<sup>36</sup>. The US, EU, and other government, business, and consumer interests have placed a high priority on fostering confidence in e-commerce by addressing concerns in four areas: (1) on-line consumer protection, (2) data protection and privacy, (3) security, and (4) payment methods. However, constructing a coherent international framework for addressing these issues is challenging because national approaches differ and technologies continue to evolve (GAO, 2002).

In the business world, there has been an ever-increasing interest in ensuring that electronic communications are afforded the quality of authenticity, integrity, and confidentiality. A handwritten signature has been the best guarantee of the first two of these qualities in a document; it uniquely verifies the person from whom the document originates, and indicates assent to the contents of the text appearing above it. Confidentiality has had to be assured by, for instance, enclosing the document in a sealed envelope (Hogg, 2000)<sup>37</sup>. Technology developed now offer a more iron cast guarantee of achieving all of these qualities using asymmetric cryptography or, as it is alternatively known, public key cryptography.

Public key cryptography does appear to be emerging as the prioritised framework for the implementation of electronic signatures in computer network communications and transactions. Its attractiveness is that although it is by far the most complex manner for generating electronic signatures this complexity is considered just what is needed in the open environment of the Internet. Public key cryptography provides not only authentication in digital signatures but also the confidentiality of strong message encryption. In addition, and perhaps crucially, public key cryptography, given a public key infrastructure, can scale within an open computer network such as the Internet. What this means is that individuals or business can communicate and transact on the Internet using public key digital signatures without having to directly negotiate the protocol for authentication. A combination of the allied confidentiality, and the potential transaction flexibility and cost savings, do seem to be leading to an effective spread of electronic signing as public key digital signatures.

The technology underpinning public key cryptography digital signatures is increasingly widely understood<sup>38</sup>. The sender encrypts his signature with his private 'signature key' and the receiver decrypts it with the public key of the sender ('signature verification key'), which could be, for example, publicly available on the Internet. Due to special mathematical features, it is computationally infeasible to get the private key using the public key ('principle of irreversibility'). Yet, there remains a risk since anyone could create an encryption and decryption key pair and therefore the receiver will not know whether the public key does in fact correspond to the purported identity (Siems, 2002). This can be minimized by the attachment of an electronic certificate (also known as Digital Certificate) by

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36 Pew Research Centre for the People and the Press, 'The Internet News Audience Goes Ordinary,' at <http://www.peoplepress.org/tech98sum.htm>.

37 Hogg (2000) at pp 37-39

certification service providers, which are also called Certification Authorities (CAs) or Trusted Third Parties (TTPs). Such service providers may be typically offshoots of ISP organisations, or of information technology hardware or software providers. A given service provider may offer a number of different services relating to necessary features of an effective public key infrastructure. Basic services include registration services for public keys; issuing of a certificate regarding a public key; key generation services; a key management service; a public key directory service; and certificate revocation service. Crucial to the PKI is the form of the certificate issued by a CSP in regard a client signatory's public key. Furthermore, other than confirming the identity of the sender, the Digital certificate can also verify other specific attributes of a person. As such, it can provide identity of CSP; name and details of signatory, validity period; unique certificate number, limitations/exclusion on third party use, details of how key generated, system for protecting signatory private key, details of revocation provisions, details of service hardware and software, and the CSP's own digital signature, referring to a public key certified by another CSP<sup>39</sup> (Murray, 2003).

Although this discussion has been limited to 'PKI' however there are already numerous forms of electronic functional equivalents to written signatures, and no doubt, many more may be developed in future. However, what all these forms of electronic signatures attempt to ensure in the framework of electronic networked communication are the functional signature requirements of authenticity, non-repudiation, and associating the body of an electronic message with the signatory to that message. At a certain level, simply typing one's name in the body of an electronic message may, together with Internet Protocol information associated with the message, offer a sufficient level of a signatory function to be acceptable for certain purposes as an electronic signature. However, given the open nature of the Internet and the sophistication of computer experts to manipulate the code that runs on the network, such an electronic signature assures very little authenticity and integrity. A secured and unique PIN attached to a message may function adequately as an electronic signature, and more sophisticated identity features such as iris scans being attached to messages would ensure an even more secure assurance of authenticity and the binding nature of the communication (Murray, 2003). However, until such technology is widely utilised public key cryptography together with digital certificates shall remain as the most the affordable form of authentication.

## **2.6 DIGITAL CHALLENGE ON TAXATION**

The fiscal consequence of the e-commerce revolution is also very difficult task for similar reasons as given above: the rate of change. *First*, There is the sheer magnitude of the increase in cross-border transactions. By significantly reducing the transaction costs of communicating and selling without regard to geographic boundaries or the size of the company, the Internet permits companies that once were confined to local markets to sell goods, services, and information internationally.<sup>40</sup> While tax

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38 An excellent introductory discussion is "Privacy on the Line", W.Diffie & S.Landau, MIT, 1999

39 For example, see X.509 Certificate Format, Ford, W. and Bauman, M.S. (2001) Chapter 6,

40 Neubig and Poddar (2000) at pp 1153, 1158.

authorities worldwide could fine-tune their existing catalogue or distance sales rules for indirect e-commerce, direct e-commerce made tax evasion easy and bears low risk. *Second*, the digitisation of information, the conversion of text, sound, images, video, and other content into a series of ones and zeroes that can be transmitted electronically creates difficulties in defining the source, origin, and destination of both production and consumption.<sup>41</sup> *Third*, the technical features of Internet transactions create enormous problems for taxing authorities in establishing audit trails, in verifying parties to transactions, in obtaining documentation, and in fixing convenient taxing points.<sup>42</sup> By eliminating the need for intermediaries, particularly financial intermediaries on which governments have traditionally relied to facilitate tax compliance through reporting obligations, the Internet enhances the danger of increased tax avoidance and evasion.

The current debate is over whether or not e-commerce sales should be taxed. Those favouring a tax assert that the introduction of an e-commerce tax would do irreparable harm to the growth of the e-commerce, as consumers will return to main-street shops. Their opponents cite concerns of lower state government revenues due to increasing e-commerce sales, the resulting decrease in public good provision, and issues regarding equity. The concern is for potential revenue loss and the uncertainties created for tax authorities.

This thesis examines several issues relevant to the current e-commerce tax debate in relation to indirect taxation. There is no doubt that any solutions that will be pursued will be constructed on compromises the need to maintain the revenue yield without placing unrealistic compliance burdens on the new businesses whose concern is understandably with markets, growth and profit and not with paying taxes. It is therefore immediately evident that it is crucial for the online entrepreneur to be aware of and fully understand all the implications of such means of indirect taxation. In the light of this, legislators are increasingly concerned about their responsibility to bring forward, as quickly as possible, solutions to solve the problems introduced by e-commerce. Without workable rules, there will be a stronger incentive, particularly for smaller businesses, simply to ignore indirect tax requirements. *'It is already the case that no consumption tax can be enforced and collected 100 percent or anything like it - the variable is always the relative size and competitive distortion caused by choosing to trade in the black economy'* (Peter, 2000).

Obviously if a country wants a competitive taxation regime and a decent level of social services then it needs a taxation base to sustain it. To stay competitive the weight must be kept off direct tax - income tax and company tax - and the indirect tax base must carry the burden of funding social services. A narrow base indirect tax cannot do it. To re-weight the tax system out of indirect tax and, by definition, into direct tax is a reverse direction. With the competitive challenges we face we cannot afford errors.

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41 Ibid

42 Owens (1997) at p 10

Narrowing our indirect tax base, and its consequence of higher direct taxes, could do us great damage.<sup>43</sup> The changes in technology and communication have brought means that bad-decision making is more evident and reaction to it faster and more severe. The advantage is greater than ever. The benefits can be greater than before but the margins for error are much smaller.

The political implications of globalisation on taxation as discussed before is even more far reaching, particularly since the history of the state is inseparable from the history of taxation. The modern state, defined by the principle of exclusive sovereignty over a bounded territory was born out of the fiscal crisis of medieval European feudalism, which by the 14<sup>th</sup> and 15<sup>th</sup> centuries was increasingly incapable of raising sufficient revenues to support the mounting expenses of warfare (Paris, 2001). The modern state was able to survive because it made fiscal sense: it was a form of political organisation that was particularly well suited to taxing wealth and commerce. Now the development of technology and the rise of international e-commerce are undermining the efficiency of the state as a taxing entity. It points to a continuing shift of taxation authority away from the exclusive domain of states and towards international forums and institutions, which are likely to play an increasing important role in the design and perhaps the administration of tax policy.

Briefly, the above argument rests on the following premises:

- that international e-commerce will continue to grow (as I have discussed before).
- that the spread of e-commerce will cause more challenges to existing system of taxation
- the national governments will ultimately demand taxation of digital commerce
- to develop effective tax collection mechanism will require utilization of technology and will require extensive international co-ordination.

It has been noted that the Chinese word for crisis combines the characters for 'danger' and 'opportunity'.<sup>44</sup> If the Internet and e-commerce are threatening a crisis for global tax administration because of the dangers they create for existing tax regimes, they have created opportunities as well.

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43 The Hon Peter Costello MP Treasurer to The Sydney Institute, Commonwealth Of Australia 'Challenges And Benefits Of Globalisation', Wednesday, 25 July 2001, The Commonwealth Treasurer - Speeches - Challenges And Benefits Of Globalisation (25-07-2001).htm.

44 *LaShawn A. v. Kelly*, 887 F. Supp. 297, 317 (D.D.C. 1995)

[www.renewlife.org/faqs/faq\\_10.htm](http://www.renewlife.org/faqs/faq_10.htm). As cited in Hellerstein, Walter (2001) 'Electronic Commerce And The Challenge For Tax Administration' Paper presented to the *United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters in Geneva, Switzerland*, on September 12, 2001

# Chapter- 3

## CURRENT TAX REGIME: DIRECT TAX & INDIRECT TAX

### INTRODUCTION

Taxation is an activity exercised by the states under the aegis of fiscal sovereignty<sup>1</sup>. It has two major roles: one is to raise the revenues of the government to cover necessary expenditures and the other is to stimulate and regulate the national economy. In fulfilment of these tasks, governments determine how much tax revenue will likely be collected and when. In practice, the operation of national tax systems often resulted in the protection of national markets against foreign products in pursuance of the goals of national economic and fiscal policy.

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<sup>1</sup> See Purcel, Thomson J.

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### **3.1 DIRECT TAX**

International taxation generally refers to the tax treatment of cross-national transactions. Since each nation has its own tax rules and the rules of one nation are rarely perfectly meshed with those of another, it is possible that income could be taxed more than once (referred to as double taxation) or that it will go untaxed by any jurisdiction. To prevent this in principal, two methods of taxation have been distinguished for direct taxes: the territorial (or source) system of taxation and the worldwide (or residence) system. Under a source system, all income earned in a country is taxed by that country regardless of whether the earner is deemed to be non-resident. A residence system taxes income regardless of where it was earned as long as the earner is deemed to be a resident of the country. Double taxation is also *guarded against through an extensive network of bilateral and multilateral tax treaties*, which attempt to allocate income earned to the source and to the residence according to 'permanent establishment' (PE).

The most important and influential model tax treaties are the OECD Model Treaty<sup>2</sup>, the United States Model Treaty<sup>3</sup> and the United Nations Model Treaty<sup>4</sup>. The provisions within these tax treaties reflect a compromise among different nations and help to resolve a number of issues such as the elimination of discriminatory tax treatment, the prevention of tax evasion through the promotion of information exchanges between administrative authorities, and the fair allocation of tax revenues. In the following sections I shall discuss (1) source-residence based taxation; and (2) the tax treaty concept of "permanent establishment" ("PE").

#### **3.1.1 SOURCE-BASED AND RESIDENCE-BASED TAXATION PRINCIPLES**

A source-based approach (sometimes referred to as a territorial approach) entitles the 'source' country to tax the income of non-residents that is earned within its borders. In contrast, under a residence-based system, a country asserts jurisdiction to tax the worldwide income of its residents, regardless of source. In the case of a company this is usually the place where the company is 'incorporated, registered', or has its 'place of central management and control' (Avi-Yonah, 1996).

Under '*place of incorporation*' a company is considered a resident if it is incorporated within the country in question. Companies incorporated outside of the country are considered to be non-residents. As such, residency can change by simply changing the country of incorporation. Further, the 'place-of-incorporation' test does not require a business to maintain an economic presence within the country;

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2 Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital (1997)

3 United States Department of the Treasury, Model Income Tax Convention, Sept. 20, 1996, 1 Tax Treaties (CCH) at p 214

4 United Nations Model Double Taxation Convention Between Developed and Developing Countries, Jan. 1, 1980, Tax Treaties (CCH) at p 206

the simple act of filing articles of incorporation will suffice to fulfil the residency requirement. Whilst clearly the 'place of incorporation' of a company provides certainty for corporate taxpayers it has been described as arbitrary and unrelated to economic reality.

The 'place of central management and control' test normally involves looking to the location of a company's head office, corporate seat or in the place where the board of directors meet. In the case of *De Beers Consolidated Mines Ltd v Howe* [1906] AC 455 which dealt with 'central management and control' demonstrate the importance of the board of directors of the foreign subsidiary carrying out their duties properly in order that the foreign subsidiary be treated as a resident of the country where the board meets. Lord Loreburn in his speech took the view that

*"In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought therefore to see where it really keeps house and does business. The decision of Kelly, CB, and Huddleston B, in Calcutta Jute Mills v Nicholson and Cesena Sulphur Co v Nicholson (1876) 1 Ex D 428, now 30 years ago, involved the principle that a company resides for purposes of income tax where its real business is carried on. Those decisions have been acted upon ever since. I regard that as the true rule, and the real business is carried on where the central management and control actually abides"* (Gordon, 1999).

In effect, 'the place of management test' is largely formal; it looks to de jure control of the foreign corporation. Consequently, the test can be easily avoided and is not effective in dealing with tax haven abuse.

However nearly all countries assert jurisdiction to tax based on the principles of both source and residence. The policies of the various countries whose constituents engage in international trade regarding source-and residence-based taxation may create the potential for the double taxation of certain cross-border flows of income. Double taxation comes in three basic forms:

- Residence-residence double taxation;
- Residence-source double taxation; and
- Source-source double taxation.

Residence-residence double taxation occurs when a taxpayer is deemed a resident of more than one nation' and each asserts the right to tax on a residence basis. Residence-source double taxation arises when one nation seeks to tax income on a residence basis and another country asserts the right to tax the same flow of income on a source basis. Finally, source-source double taxation exists when each of two nations that tax on a source basis considers a particular flow of income to have a domestic source (Mitchell, 1997).

To avoid double taxation, 'one principle must yield to the other'.<sup>5</sup> Common bilateral tax treaties solve the double taxation problem by restricting the taxing rights of the source country, which correspondingly increases the taxing jurisdiction of the residence country. Where a source country

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<sup>5</sup> Treasury Paper at p 7.1.5

retains its rights to tax a particular flow of income, the country of residence may avoid double taxation on that income in one of two ways:

- By granting a credit to its resident taxpayers for taxes paid to the foreign jurisdiction;  
or
- By exempting the foreign source income from the taxable income base of its taxpayers<sup>6</sup>.

Foreign tax credits, however, do not always alleviate the burden of double taxation. The United States, for example, will not allow a tax credit in a source-source double taxation situation, where both the United States and another country deem a certain item of income to have a domestic source. In such a situation, the taxpayer, for U.S. tax purposes, does not derive any foreign source income. Since the existence of foreign source income is essential to generating a foreign tax credit for U.S. tax purposes double taxation will persist in such a case.

Because the source-source situation creates the potential for double taxation without any corresponding relief from foreign tax credit provisions, it remains particularly problematic. Conversely the source-source situation also carries with it the risk of tax avoidance. A tax avoidance opportunity could arise when each of two countries considers an income flow to have a foreign source, and neither country asserts jurisdiction to tax on a residence basis. Since most countries employ both residence-and source-basis taxation, this tax avoidance scenario should not arise too often (Sweet, 1998).

### **3.1.2 PERMANENT ESTABLISHMENT**

The concept of a Permanent Establishment ('PE') is probably the single most important concept found in tax treaties since it serves to establish taxing jurisdiction by the source country over a foreigner's unincorporated business activities (including activities of a branch) (Levine and Weintraub, 2000). The non-resident enterprise's profits from business activities are taxable by the source country only if the enterprise has a PE located in the source country<sup>7</sup>. As will be seen further

*'The purpose of the permanent establishment rules is to specify under what conditions a resident of one country will be subject to taxation in a second country. If a resident of the first country has a permanent establishment in the second country, he may subject to tax in that second country, otherwise he is not taxable on business profits' (Peschcke-Koedt, 1998).*

Source-country income taxes are generally only applied to active business income when a PE (that must be an unincorporated company and thus not a legal entity) exists within its borders. If no PE exists within the source country, the business profits would thus either escape taxation or, as is typically the case, would be taxed by the residence country. PE is defined in Article 5(1) of the OECD Model Tax Convention and is interpreted in the commentary as containing three conditions:

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<sup>6</sup> Treasury Paper at p 7.1.2.

<sup>7</sup> Organisation For Economic Co-Operation And Development, Model Tax Convention On Income And On Capital (1997) (hereinafter OECD Model Treaty)

- The existence of a 'place of business', i.e. a facility such as premises or, in certain instances, machinery or equipment;
- This place of business must be 'fixed', i.e. it must be established at a distinct place with a certain degree of permanence; and
- The carrying on of the business of the enterprise through this fixed place of business. This usually means that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

Each of these three conditions must be met before activity of a business enterprise can be deemed to result in a PE, and together they are often termed the 'fixed place of business test'. The place of business is usually the location where the business activity of the foreign company occurs, but the necessity of satisfying all three requirements sometimes leads to different results. The term 'fixed' is typically broken into two components, 'spatial and temporal'. One refers to a geographical status within the taxing state; the other refers to a time component. In other words, the business activity must be able to be linked to a specified geographical area<sup>8</sup> and the activity must not be of a purely temporary nature.<sup>9</sup> However, many businesses are able to function without the use of a traditional fixed status, thereby complicating the determination of the geographical status requirement (Sheer, 1999). There are, however, a number of 'fictions' set out in provisions of the model tax treaties that attempt to circumvent the requirement of geographical and temporal 'permanence'. These fictions ensure that certain temporary and mobile activities are caught by the definition of PE. For example, there are provisions to ensure that the income generated by entertainers could be taxed in the source state despite the absence of any real fixed place of business<sup>10</sup>.

In addition to this commentary accompanying OECD Model Tax Convention<sup>11</sup> and other convention Models specifically identifies certain type of activities that may be a PE which includes especially: place of management; a branch; an office; a factory; a workshop; a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. This list is illustrative and non-exclusive.

*"A general principle to be observed in determining whether a permanent establishment exists is that the place of business must be fixed in the sense that a particular building or physical location is used by the enterprise for the conduct of its business, and that it must be foreseeable that the enterprise's use of this building or other physical location will be more than temporary"*<sup>12</sup>.

Any other type of establishment that satisfies the requirements of being a fixed place of business but is not on the list must be considered as establishment. Although the list seems to indicate physical *situs* where individuals may be employed, it is not a requirement that an enterprise employ individuals in order for a PE to exist. Physical objects not specifically enumerated in Article 5(2) may constitute a PE.

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<sup>8</sup> Geographical status was easily identifiable as a plant, office or factory.

<sup>9</sup> OECD Model Treaty, commentary to art. 5, at p 5 'the place of business has to be a 'fixed' one. Thus in the normal way there has to be a link between the place of business and a specific geographical point.' ('Permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature.')

<sup>10</sup> OECD Model Treaty, art. 17.

<sup>11</sup> OECD Model Treaty, commentary to art. 5, at p 2-30.

<sup>12</sup> United States Model Income Tax Convention. Technical Explanation, paragraph 69.

Examples of such physical objects are vending machine, automatic filling stations and other automated facilities.<sup>13</sup>

Another type of PE is the agency type. The basic concept is that the presence of the specified type of agent is essentially like a fixed place of business of the principal. Neither the principal nor the agent needs to have a physically fixed place of business to fit into this PE definition. Essentially, the focus is on whether the foreign entity (the principal) has an agent in the country and whether that agent exercises the authority to conclude contracts on behalf of its principal (Peschcke-Koedt, 1998).<sup>14</sup> Article 5(5), the agency PE provision in the OECD Model Tax Convention, describes situations in which an enterprise will be deemed to have a PE regardless of whether it has a physical presence in the source state<sup>15</sup>. Under Article 5(5), even if an enterprise does not have a fixed place of business in the source state, PE shall be deemed to exist where:

- A person of an independent status
- acts in one contracting State on behalf of an enterprise of the other contracting State and
- has an authority to conclude contracts in the name of that enterprise and
- habitually exercises such authority. Thus, companies who have salespersons making trips in and out of the source country are not considered to have a PE under the OECD Model Tax Convention agency provision unless the salespersons meet these four requirements.

The first requirement, that the person (agent) be dependent, is usually satisfied where the person is an employee of the company, but not where the person is self-employed and performs similar activities for more than one principal. However, the third and fourth requirements (having authority to conclude contracts that bind the principal and habitually exercising that authority) are good indicators of such status. But, as in the 'fixed place of business' discussion above, even an agent who acts on behalf of an enterprise, has the authority to conclude contracts, and habitually exercises that authority will not constitute a PE of the company if the agent's activities are preparatory or auxiliary in nature as defined in Article 5(4) (Thorpe, 1997). If no PE exists within the source country, the business profits will thus either escape taxation or, as is typically the case, will be taxed by residence country.

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<sup>13</sup> The issue regarding the conduct of business of the enterprise through automatic equipment and the commentary on Article 5(10) of the OECD Model Convention is discussed in detail in Chapter-5 while discussing PE and E-Commerce.

<sup>14</sup> Lisa Peschcke-Koedt (1998) at p 1603.

<sup>15</sup> Article 5 of the U.S. Model Treaty defines a permanent establishment as 'a fixed place of business through which the business of an enterprise is wholly or partly carried on'. A later provision excludes from the definition of a permanent establishment a number of auxiliary activities, including 'the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise' and 'the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise'. These exclusions would seem to cover many of the activities that computer servers or websites perform.

The PE concept represents a practical way of ensuring foreign income taxes would only be applied to substantial recurring business within foreign countries. The commentary to the OECD Model Tax Convention indicates:

*“It has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights”.*<sup>16</sup>

A more cynical view might suggest that the PE concept arose from the economic dominance of industrialised nations who favoured residence-based taxation since they were generally capital exporters when the rules were initiated. In fact, many developing nations have opposed the PE principle almost since its inception.

## **3.2 INDIRECT TAX**

Consumption taxes are an important source of revenue for most of the governments around the world. They either follow the European model of Value Added Tax (VAT) or the USA model of Retail Sales Tax (RST).

### **3.2.1 VALUE ADDED TAX**

VAT is an indirect, multi-stage consumption tax. As an *indirect tax*, the VAT is levied upon the articles of trade before they reach the customer, who eventually pays the tax-inclusive market price.<sup>17</sup> The label ‘indirect’ follows from the fact that the payer of the VAT does not suffer a corresponding reduction in their from such purchases. VAT is insensitive to individual circumstances of the taxpayer following from its ‘indirectness’ and it is not an effective means of redistribution. Therefore, its chief role is to raise government revenue without influencing consumption patterns. Indeed, it is the unprecedented revenue-productivity of this tax what makes it appealing to many states.<sup>18</sup> In order to preserve neutrality, the VAT system should provide a comprehensive tax base, be of a uniform rate and have limited exemptions. Application of multiple rates and broad range of exemption increases administrative and compliance burden and distorts consumer choices.

As a *multi-stage tax* the modern VAT collects revenue at all stages of production and distribution.<sup>19</sup> In close connection with the multi-stage nature of this tax, VAT provides for the right to recoup the tax paid by the business participants of the supply-chain. The right to regain the VAT is put into practice by the application of the credit-invoice administrative method (Schenk, 1999). The credit invoice method requires taxable persons to calculate VAT at the appropriate rate on all taxable supplies made (outputs) throughout the chain of supply, through this invoice /credit mechanism, a business is responsible only for that part of the VAT attributable to the value that it adds in its stage of production

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<sup>16</sup> OECD Model Treaty, Commentary to art. 7, at p 3

<sup>17</sup> Schenk and Oldman (2000) Value Added Tax, at p 12.

<sup>18</sup> Tait, Value Added Tax at pp 21-24

(Taylor, 2000). The right to recoup the tax makes it possible to avoid the negative consequences of tax 'cascading'.<sup>19</sup> Being exactly proportional to the price makes VAT neutral both with respect to the length of the production and distribution chain (internally) and with respect to the relative tax burdens on domestic and imported goods in the market place (externally). Because it is proportional to the price and it is measured by the contribution of value added, it is also neutral as to the method of commerce.

As a *consumption tax* VAT is applied to a base consisting of personal expenditure.<sup>20</sup> The last link in the chain bears the tax: normally the consumer. If taxes are fees for public services, burdening the VAT on final consumption is justified by the fact that consumers are the main beneficiaries of public services (Terra, 1998). Being a consumption tax, the VAT not only aims at taxing final consumption but also at taxing it at the place of consumption.<sup>21</sup> This ambition gains the most importance in the context of the inter-jurisdictional application of VAT. In case of cross-border transactions more tax jurisdictions are concerned with the taxation of the sale. To designate the country of taxation there is a need for special, so-called 'place-of-supply' rules.<sup>22</sup> These rules, by resolving potential conflicts between the jurisdictions pursue the goal of avoiding double-taxation or accidental non-taxation.<sup>23</sup>

The administration of the border tax adjustments under the destination principle requires close cooperation from the tax administrations of the countries involved in the transaction. To avoid double- or non-taxation it is necessary to keep track of the cross-border movement of physical goods<sup>24</sup>. This is only possible through the checking of the documentation of the merchandise at the border. As a result, there is a need for border controls. As opposed to the destination principle, the origin principle assigns taxing jurisdiction to the exporting country<sup>25</sup>. The destination country charges no tax. Under this solution importers in each country compare the tax-inclusive prices of domestic and foreign goods. There are no border tax adjustments under this scheme; consequently there is no need for border controls. Application of this principle is not common, since it directs all revenues from the VAT imposed on international trade to the country of origin. As seen above, this practice conflicts the ambition of the VAT to tax consumption at the place of consumption. The most common way of determining the place-of-supply rules is based on the destination principle. According to this principle the exporter receives a tax rebate in the amount of the VAT levied on the goods and services that are being exported.<sup>26</sup> This practice is referred to as zero-rating. Zero-rating is a special type of exemption under which the exporter charges a rate of 0% on the tax base and retains the right to claim back his

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19 Schenk and Oldman (2000) Value Added Tax at p 29

20 Unless the tax paid by the business can be reclaimed the value previously taxed and the previously paid tax itself are again subjected to tax in the next stage of sale. This practice leads to serious price distortions or to the vertical integration of businesses to avoid accumulation of tax through several stages of sale.

21 Schenk and Oldman (2000) Value Added Tax at pp 7-12.

22 Ibid at p 260.

23 Ibid at pp 269-272

24 This object of the place-of-supply rules has also been acknowledged by the ECJ, see Case 168/84 *Berkholz v Finanzamt Hamburg-Mitte-Alstadt* (1985) ECR 2251, and Case C-327/94 *Dudda v Finanzamt Bergisch Gladbach* (1996) ECR I-4595

25 Supra Note 17 at p 262

26 Ben Terra (1998) *The Place of Supply in European VAT*

27 Supra note 21 at p 260

input-credits.<sup>28</sup> As the outcome of the destination principle the international trade in goods and services is based on net-of-tax prices<sup>29</sup> therefore the effects of the differences between national tax rates is neutralized. Eventually, the destination country taxes the imported product usually only upon resale by applying its own rate. The VAT system also relies on the reverse charge or self-assessment method for applying and accounting for VAT in case of cross-border transactions. Where a person outside the country supplies relevant services to a person in the country in connection with the recipient's business, the recipient is treated as though the recipient supplied and received the service and thus accounts for output VAT based on the value of the service received and at the same time recovers this VAT as input VAT if it relates to a taxable supplier. This obligation of the local person to account for reverse charge VAT addresses the problem of tax avoidance or evasion on the part of the foreign supplier and of the competitive advantage of lower VAT rates applicable to suppliers established in certain member states.

In the European Community the application of the VAT scheme is governed by a series of Directives and Regulations. The first VAT directive is fundamental to the EC VAT system, setting out in its recitals and first two articles the principles on which the system is designed. The recitals record the necessity of a common form of consumption tax to avoid both distortions of competition and hindrances to the free movement of goods and services.<sup>30</sup> They also record that the aim of establishing the highest degree of simplicity and neutrality is best achieved when the tax is as general as possible, but that this aim may not be achieved immediately.<sup>31</sup> The principle of VAT is stated in Art 2 of the first VAT Directive (1967)<sup>32</sup> as follows:

*'The principle of the common law system of value added tax involves the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transaction which takes place in the production and distribution process before the stage at which tax is charged. On each transaction, value added tax, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of value added tax borne directly by the cost components.'*

The detail of the common VAT was left to the Second Directive. However, the Second Directive answered only of the issues necessary to establish a truly common form of Vat in the community. It also allowed member states to retain significant derogations from the common form of the VAT in a number of sensitive areas. The most important area of inconsistency left by the Second directive was that it was for member states to decide which goods and services were within the charge to tax and which are to be exempted from it. Other deficiencies included national differences in identifying which should be subject to VAT and how VAT was applied to both imported goods and cross-border supplies of services. In other words, the VAT adopted in each member state might have common principles, but it was short of being a common tax. The concern for harmonisation arose because a portion of Member States' VAT revenue was to become a main Community's own resource. Work therefore started to

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28 Supra note 21 at p 227

29 Supra note 26 at p 5

30 Directive 67/277/EEC, Recital 2

31 Directive 67/277/EEC, Recitals 5,6

32 Directive 67/227/EEC (OJ 1967 1301)

replace the Second Directive with a more detail provision consistent with the principle of the First VAT Directive.

**A. Sixth VAT Directive**

The sixth VAT Directive was adopted to replace the Second Directive in 1977 and this Directive is the most comprehensive one in the series of VAT directives and provides the grounds for further harmonization. It provided a common set of rules for several questions: taxable persons subject to the tax; territory covered by the tax; common definition of taxable transactions; common rules for identifying where and when a taxable transaction occurs; common valuation rules; a common list of exemptions. The following summary confines itself to the rules of the consolidated Sixth Directive relevant for the purposes of this thesis.

By 1990, the common form of VAT was becoming a reality. Besides the framework directives, several other Directives had provided regulation for mutual assistance of tax authorities,<sup>33</sup> measures allowing traders from other states and from outside the EC to claim VAT refunds in appropriate cases,<sup>34</sup> and some moves towards various national derogations.<sup>35</sup> European court began to provide interpretation the directives although the first substantive VAT case had not come before the European Court until 1976,<sup>36</sup> and the first case alleging specific infraction under VAT Directive against a member state was not heard until 1984.<sup>37</sup> By 1990, however, the case law was becoming an important aspect of the development of tax. Despite comprehensive legislation and judicial activity, VAT was still a tax requiring border controls. Each exporting state removes any VAT from exported products and refunds it to the exporter. The importing state then intercepts the imported goods in the same way as for custom duty, and imposes a VAT charge on the value of goods at the import. In effect, therefore much of VAT on goods is collected in exactly the same way as if VAT on imports was a customs duty. This approach could not be maintained in a single market without internal frontiers. The reason why border controls are needed was because VAT was imposed as destination-based tax. In the view of the Commission, and various committees, VAT could avoid the problems of border controls only if it become an origin based tax, or at least an origin collected tax.<sup>38</sup> However the Commission failed to persuade all the member states, although a compromise was adopted<sup>39</sup>. Under the agreed approach, the origin basis of

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33 Article 28 of the Sixth Directive preserves the right to continue existing derogation from the Second Directive.

34 The Eighth VAT Directive (79/1072/EEC) of 6 December 1979 (1979 OJ L 331/11), dealing with traders in other EC states and the Thirteenth VAT Directive (86/560/EEC) of 17 November 1986 (1986 OJ L 326/40), dealing with traders in third states.

35 The Eighteenth VAT Directive (89/465/EEC) of 18 July 1989 (1989 OJ L 226/21) abolishing some of the derogation permitted by art 28(3) of the Sixth Directive.

36 *Mazzalai Case 111/75*, (1976) ECR 657

37 *EC Commission v Belgium Case 325/82*, (1984) ECR 777

38 An origin-based VAT is one where liability is imposed in, and revenue is retained by, by the state export. An origin-collected tax is one where liability is imposed in the state of export on behalf of the state of import. The export state must therefore account in some way to the import state for the VAT on any export between the states. In effect, VAT is collected as a sort of withholding tax in this case. An origin-collected tax therefore requires some kind of clearing system at Community or national level between member states.

39 Art 28 and following articles of Sixth VAT Directive.

VAT was adopted (without any clearance procedure) for mail order goods, excise goods and new means of transport. In all other cases, the existing system was to remain. In order to make a VAT charge on imports work without customs controls, a series of inward processing controls were used instead, requiring accounts from person to whom goods bought by cross-border acquisition were delivered. Article 2 of the Sixth VAT Directive defines the scope of VAT to include: the supply of goods and services within the territory of the country by a taxable person, the intra-Community acquisition of goods within the territory of the country by a taxable person or a non-taxable legal person, and the importation of goods.

Since 1 January 1993, the system of taxation of 'imports of goods' from other Member States has been replaced by 'intra-Community acquisitions of goods'. That of 'intra-Community supplies' has replaced the system of 'exports of goods' to another Member State. The new system is still based on the principle of taxation according to destination, but the formalities take at the destination point rather than the border. The following conditions must be exchanged between taxable persons, dispatched or transported to the acquirer by, or on behalf of, one of the taxable persons, from one Member State to a Member State other than that from which the goods are dispatched or transported. Intra-Community supplies are exempt, in the Member State of the enterprise, which sells them, and are taxable in the Member State where the goods arrive. The taxable person thus reports the output VAT on his VAT return and deducts the input VAT on the same return, if he has the right. Member States thus fully preserve their fiscal sovereignty: the Member State of arrival ensures that the goods acquired are subject to taxation; the Member State of the seller, or of origin, does not have to ensure that the goods are effectively as intra-Community supply. Goods purchased (origin-based VAT included) by a private individual, Member State. However, purchases from mail order companies, including all sales in which the vendor is responsible for shipments are taxable in the country to which they are sent, if the dispatch is on behalf of a supplier whose total sales in that country exceed a threshold value. This is the 'distance selling exception' to the system of origin-taxation applicable to private consumers affecting their purchases in another EC-jurisdiction.

#### **B. Taxable person**

Under Article 4(1) of the Sixth VAT Directive taxable person shall mean any person who independently carries out, in any place any economic activity defined to include all activities of producers and traders. An economic activity is defined as "all activities of producers, traders and person concerning services...A person who carries on an economic activity under an act of employment, does not carry on the activity independently"<sup>40</sup>.

The operation of this provision is again a mixture of EC provisions and national law. Hence a taxable person is defined under VATA 1994 as a person who is, or is required to be, registered under the Act<sup>41</sup>. The status of such persons can take the form of a private individual, a partnership, a private or public

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<sup>40</sup> Sixth VAT Directive, Directive 77/338 Art.4 (2) and Art 4 (4).

<sup>41</sup> VATA 1994, S. 3(1)

incorporated body, government bodies and non-profit making organisations. A person is a 'taxable person' if registered or required to be registered under the VAT law of a member state. It is for the member state to determine precisely how and when the registration duty arises and is fulfilled. The Sixth Directive provides only a framework within which this duty arises<sup>42</sup>. The Directive also gives member states discretion to exempt taxable persons from duty to collect the tax below a nationally determined threshold.<sup>43</sup> Taxable persons are obliged to report the commencement of and any change in their taxable activity. They should keep sufficient accounts of their finances and issue an invoice when supplying to another taxable person. Taxable persons are required to submit their return at the end of each taxing period and pay the VAT due. Once a person is registered or required to be registered under national law, every taxable person is allocated a unique identification number by the tax administration, which is usually distinguishable solely for VAT purposes. Verification of the taxable status bears outstanding importance in cases of cross-border supplies to businesses, where the Sixth Directive assigns tax liability to the business recipient of certain services under the so-called 'reverse charge'<sup>44</sup> method. To be able to disregard further VAT obligations, the supplier should be certain about the taxable status of its customer. Identification of registered business with regard to intra-Community transactions is facilitated by the VAT Information Exchange System<sup>45</sup> (hereinafter referred to as: 'the VIES'). According to Article 6 of the Council Regulation on Administrative Cooperation in the Field of Indirect Taxation (EEC) No 218/92 governing the VIES, the competent authority of each Member State shall ensure upon request that persons involved in the intra-Community supply of goods or services obtain confirmation of the validity of the VAT registration number of any specified person.

### **C. Taxable Transaction**

Taxable transactions include the supply of goods and the supply of services. The *Supply of goods* is defined as the transfer of a right to dispose of tangible property as owner.<sup>46</sup> The *Supply of services*

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42 Art 4

43 Art 24

44 As I have discussed before in this chapter the rationale behind the reverse charge or self-assessment system is the wish to ensure taxation at destination. However, application of reverse charge is merely viable in case of business recipients, who have the sufficient means to fulfil such obligation and are motivated for compliance by the right to deduct the input credits. Final consumers lack both; moreover the lack of audit-trail would render enforcement impossible. Consumption Tax Aspects of Electronic Commerce, A Report from Working Party No. 9 on Consumption Taxes to the Committee on Fiscal Affairs, OECD, 15 (2001)

45 The VIES was established by Council Regulation on administrative cooperation in the field of indirect taxation (EEC) No 218/92 (hereinafter; 'the VIES Regulation') OJ L024 01/02/1992 p. 0001. It is a common system for the exchange of information on intra-Community transactions for tax purposes. It has been set up for the supplementation of the Sixth Directive after the introduction of Council Directive amending the Sixth Directive with a view to the abolition of fiscal frontiers (91/680/EEC) OJ L376 31/12/1991 p. 1. Elimination of border controls necessitated closer cooperation between national tax administrations. See Recital 3 of the VIES Regulation.

46 Article 5 of the Sixth Directive, Sixth Council Directive on the harmonization of the laws of the Member States relating to turnover taxes (77/388/EEC) OJ L145 13/06/1977

means any other transaction not constituting a supply of goods.<sup>47</sup> By means of this catchall definition the Directive intends to ensure that intangible supplies do not escape taxation.<sup>48</sup>

#### D. Place of Supply

The place of taxation with respect to *goods* is determined upon the physical location of the goods concerned regardless of where the parties reside.<sup>49</sup> The meaning of a supply of goods has received judicial consideration. In the ECJ decision, known as the *Theotru* case the following explanation of what is a supply of goods is given “*supply for such purposes in relation to goods requires the transfer of goods from one taxable person to another, either immediately or at a future date, and implies the existence of the goods such time of transfer*”<sup>50</sup>. It is important to make a distinction between the physical product and the property that exists within that product. A VAT is charge only arises where the property in the goods is: transferred by sale; possession of goods is transferred under an agreement for sale of the goods; or possession of goods is transferred under agreements, which expressly contemplate that the property will also pass at some time in the future. Goods imported from outside the EU are liable to VAT at importation; goods delivered from one Member State to another are taxed in the country where the transport of the goods begins, unless supplied to VAT registered customers, in which case they are taxed as an acquisition in the Member State of receipt. Supplies of goods to non-taxable persons may be taxed in the supplier’s Member State, subject to the total value of supplies in any single Member State remaining below a threshold<sup>51</sup>. The place of supply rules for services is much more complicated and can be either the place where the supplier is situated or the place where the customer is situated depending on the category of the services in question.<sup>52</sup> For purposes of administrative feasibility place-of supply rules for services may further differ in accordance with the type of service.

As discussed before the Community faces a serious dilemma when trying to choose among the principles underlying the place-of-supply rules. How to choose between these principles? Both the destination and the origin principles have their positive and negative points when considered within the special context of the internal market. The precise and expeditious border tax adjustments of the destination principle satisfy the requirement that intra-Community competition should not be distorted and the free flow of goods and services should not be hindered through the application of indirect taxes.<sup>53</sup> It also satisfies the general requirement of VAT of allocating the tax into the country of

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47 Article 6 of the Sixth Directive

48 Schenk and Oldman (2000) Value Added Tax, at p 139; Tait (1998) Value Added Tax, at p 387

49 Article 8 of the Sixth Directive

General rules in Art 8 apply to determine where goods are supplied: ‘for goods dispatched or transported: the place where the taxable transaction is effected is where the goods are at the time dispatch or transport begins.

For goods not dispatched or transported: the place where the goods are when supply takes place’.

50 In the ECJ decision, known as the *Theotru* case (1983) VATTR 88 at p 92

51 As discussed before in Taxable Person section

52 Article 9 of the Sixth Directive

53 Articles 2 and 14 of the Treaty of Rome Treaty Establishing the European Community, March 25, 1957, consolidated version in Official Journal C340 10/11/1997 at pp 173-308, Tait (1998) Value Added Tax

consumption. The serious drawback of this principle is its essential co-existence with border controls. These border controls, by necessitating the presence of the same infrastructure at the borders as would be in place were the Community not a customs union, are incompatible with the idea of a true European common market described in the Treaty of Rome.<sup>54</sup> The most appealing feature of the origin principle is the lack of need for border tax adjustments. The inability of the origin principle to concentrate the VAT revenue to the country where consumption takes place conflicts the general requirements of a consumption-based taxation scheme. With respect to the interests of the Community, dislocation of VAT revenues among Member States would distort competition within the common market.<sup>55</sup>

Abolishing the tax-frontiers has been the ultimate goal of the Community from the outset of the harmonization process.<sup>56</sup> Accomplishment of this goal only seems possible through the application of the origin principle; despite this fact place-of-supply rules have been guided predominantly by the destination principle since the adoption of the First Directive. The fragmentation of the internal market following from the operation of border controls has indeed been acknowledged by the Commission in its White Paper<sup>57</sup> issued in 1985. This document proposed a so-called 'definitive system' of VAT built on the origin principle and the parallel operation of a clearing-house. Fearing to lose fiscal sovereignty the Members have yet been unwilling to take the measures necessary for the introduction of a clearing-house. According to Terra and Kajus (1992) introduction of the clearing-house is impossible if there are significant tax and consequent price differences between the Member States. Agreement on the way of determining the shares of the Member States from the VAT revenue would also be essential. However the Commission made persistent efforts in its subsequent series of proposals during the last decades to reconcile the conflicting interests of the internal market and the Member States.

At present place-of-supply rules are based on 'interim system' that was introduced by a Council Decision, which, as the first step toward the implementation of the origin principle, terminated border controls from 1993.<sup>58</sup> According to this regime sales to consumers have become subject to the origin principle, while the destination principle remained effective for sales to business customers. The 1993 system is known as the 'transitional system', it will be probably be replaced by a 'definitive system for taxation of trade between Member States based in principle on taxation of origin of the goods or

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54 Tait (1998) at p 158

55 Application of the origin principle results in a VAT burden on imported products. The country of import therefore should grant an input credit to the importer to avoid tax cascading. This, however, would mean that the importing country did not only miss the revenue from tax but suffered a positive loss by granting the input. In case of not granting input credit to the importer, imported products will become more expensive following from the tax cascading. Tait (1998) Value Added Tax, at pp 437-444.

56 Report of the Fiscal and Financial Committee in The EEC Reports on Tax Harmonization (International Bureau of Fiscal Documentation, 1963) 'Neumark Report', cited in Schenk and Oldman, Value Added Tax at p 437

57 Completing the Internal Market: White Paper from the Commission to the European Council, June 28-29, 1985 (COM (85) 310)

58 Council Directive amending the Sixth Directive with a view to the abolition of fiscal frontiers (91/680/EEC) OJ L376 31/12/1991 p. 1.

services supplied'<sup>59</sup>. The definitive system should be effective, modern and neutral, treating intra-Community transactions in much the same manner as domestic transactions, in accordance with the concept of an internal market. However, as the Council reached no replacement decision by 31 December 1996, the trans-national arrangements of 1993 continue to apply until the Council decides on the definitive system.

### **3.2.2 SALES TAX**

Sales tax is a tax on the retail sale of specified tangible property or services which has historically been sold over the counter to the buyer and collected at the location where the good is transferred from the seller to the buyer. This will include personal property and in some cases intangible property is also subject to sales tax as tangible personal property- e.g. computer software is sometimes considered tangible and therefore taxable. Real property is usually not subject to sales tax, but may be subject to transfer tax<sup>60</sup> (Hellerstein, 1992). Three factors determine whether sales tax liability in a particular state exists for a transaction: (i) The type of good being sold, (ii) situs, or the location where the transaction takes place, and (iii) nexus.

In a single stage tax model, a sales tax is applied only once in the production and distribution channels where as in a multistage tax model sales tax is imposed at all stages in production and distribution. Thus sales tax may be applied to the sale by manufacturer to the wholesaler or to the retail sale. In the traditional 'consumer levy' tax jurisdiction, the buyer pays the tax at the time of the sale, and the seller collects and remits the tax as an agent for the taxing jurisdiction; they are not collected directly by the government. Purchases by businesses either for resale or as inputs to production are (in theory if not always in practice) exempted from sales taxes in order to avoid double taxation. In absence of a remedial provision, the mere imposition of a sales tax by the purchaser's state could easily be circumvented by arranging for the sale to take place in the seller's state or a third state even though the purchase item is used in purchaser's state. Consequently the states that impose sales tax also impose a use tax for goods purchased outside the state that are used with the state<sup>61</sup>. Hence, a sales tax regime is actually made up of two separate taxes, sales tax and use tax.

What is Use tax? 'Use' would be defined typically as an exercise of a right or power to use, consume, possess, or store that is acquired by a sale for use of tangible personal property, or a taxable service.

The use tax is an

*"Ingenious legal device that was developed to safeguard state sales tax<sup>62</sup> by imposing tax on the privilege of using, consuming, distributing or storing tangible personal property after it is brought into the State from without the State"<sup>63</sup>(Hellerstein, 1998).*

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59 Art 35a of Sixth Directive

60 Hellerstein (1992) at pp 13.01, 13.05

61 State's authority to levy these taxes is derived from the 10th Amendment of the U. S. Constitution, which states 'The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the states respectively, or to the people.' U.S. Const. amend. X

62 *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967).

The use tax is designed to capture sales tax revenue that would otherwise be lost, since the sales transaction, which is ordinarily the point of collection, occurred out of state. The use rates are generally the same as the sales tax rates, and the payment of a sales tax to an out of state vendor will usually qualify as a credit towards the use tax (Hellerstein, 1998)<sup>64</sup>. This credit mechanism attempts to prevent double taxation of the same item. Most states require the consumer to self-assess the use tax, since the only collection agent (the seller) in the transaction does not have a taxable, physical presence in the reporting state. However, if the seller has the requisite taxable nexus in the consumer's home state, the state can impose a sales tax collection obligation on the seller, thus guaranteeing the collection of the tax (Ciline and Neubig, 1999). The obligation is imposed in return for the seller having purposefully availed it of and benefited from the taxing state's laws and market.<sup>65</sup> The use tax is theoretically effective when applied to sales of tangible personal property, but cannot ordinarily be enforced as a complementary tax against services purchased out of state but performed in state. As a practical matter, however, use taxes are often totally avoided unless a collection burden is imposed on the seller (Ciline and Neubig, 1999)<sup>66</sup>. This is especially true for individual consumers, as opposed to business consumers, since unlike individuals, many business consumers undergo regular use tax audits<sup>67</sup>.

United States is an ideal example of myriad and multiple sales tax system hence it can be used to illustrate the international sales tax principles of cross-broader e-commerce sales tax issues. The first barrier to state taxation is the United States Constitution. Under the Constitution<sup>68</sup>, states may not tax out of state sellers unless the imposition of the tax meets the *Due Process clause requirement of* minimum contacts and the Commerce clause requirement of physical presence.

#### **A. Due Process Clause**

The Due Process clause<sup>69</sup> ensures fairness in the operations of the state governments towards its citizens. No one should be deprived of 'life, liberty, or property' including tax dollars, without due process of law. Due Process has been interpreted in this context as requiring that a taxpayer should have at least some minimum contact with a jurisdiction, 'such that the maintenance of a suit (or, in this

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63 Hellerstein (1998) at p 16.01

64 Hellerstein (1998) at 16.01, 16.11(3),

65 Ibid.

66 Ciline and Neubig (1999) at p 5

67 National Governor's Association data located at <http://www.nga.org/internet/Proposal.asp>, last visited on 2-11-2000, indicating up to 500 audits per annum for multistate sellers.

68 *National Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U.S. 753 (1967), holding that an Illinois use tax statute violated the Fourteenth Amendment's Due Process clause and created an unconstitutional burden on interstate commerce. The Court imposed the minimum contacts requirement in context of Due Process

69 The Due Process Clauses of the United States Constitution (Fifth and Fourteenth amendments) state: "No person shall ... be deprived of life, liberty, or property, without due process of law." U.S. Const. amend. V. "Nor shall any State deprive any person of life, liberty, or property, without due process of law ...." U.S. Const. amend. XIV, 1.

case a tax) does not offend the 'traditional notions of fair play and substantial justice'.<sup>70</sup> The Due Process analysis centres on whether a taxpayer's connections with the jurisdiction are sufficient to give notice that it may be haled into court, or subject to a tax, in that jurisdiction<sup>71</sup>. For present purposes the Due Process clause requires that a seller meet minimum thresholds of activity (which need not equate to physical presence) with a state before that state can impose a tax on the seller, or an obligation to collect that tax from in-state buyers<sup>72</sup>. However, even if a taxpayer exceeds the Due Process limitation, it must also exceed the physical presence requirement of the Commerce clause before taxation can occur.

## **B. Commerce Clause**

The most obvious source of federal power to regulate federal and state taxation is the so-called Commerce Clause of the U.S. Constitution<sup>73</sup> 'Congress shall have the power to regulate commerce ... among the several States'. The Commerce clause is more restrictive than the Due Process clause, in that it requires more than a minimal connection with the taxing state before taxation can occur<sup>74</sup>. The Commerce clause requires that a taxpayer establish a 'substantial nexus,' defined as physical presence with a state, before the state can impose a tax. However, the Commerce clause has a negative implication, the so-called 'dormant Commerce clause,' which prohibits a state from taxing if the tax has the effect of restraining interstate business. The dormant Commerce clause allows Congress to prevent the states from imposing taxes that are restrictive of interstate commerce. It also allows Congress to require minimum standards, such as physical presence in the state, before taxation can occur (Edson, 1996). Congress could eliminate (or expand upon) the judicially created physical presence test; the minimum connection required by the Due Process clause, by contrast, can only be changed by an amendment to the Constitution.

## **C. Judicial Interpretations**

In 1967, the Supreme Court first applied the dual analysis of the Due Process clause and the Commerce clause to a tax imposed on an out-of-state mail-order seller. In *National Bellas Hess, Inc. v. Department of Revenue*<sup>75</sup>, the Supreme Court addressed a challenge involving the application of the Illinois use tax to a Missouri mail order house that owned no property and had no sales outlets or employees in Illinois.

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<sup>70</sup> *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945). The Court found that due process requires that a defendant have minimum contacts with the jurisdiction.

<sup>71</sup> *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 476 (1985). The Court held that if one purposefully engages in significant economic activities in the state, he 'manifestly [avails] himself of the privilege of conducting business there', and because his activities are subject to the 'benefits and protections' of the forum's laws it is presumptively not unreasonable to require him to submit to the burdens of litigation in that forum as well.'

<sup>72</sup> *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967). However, it was not until the Court's ruling in *State of North Dakota v. Quill Corp*, 504 US 298 (1992), that the distinction between Due Process (minimum connection) and Commerce clause (physical presence) nexus was established.

<sup>73</sup> U.S. Constitution Art. I, 8 cl.3.

<sup>74</sup> *State of North Dakota v. Quill Corp*, 504 US 298, 313 (1992).

<sup>75</sup> *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753 (1967).

*National Bellas Hess* simply used the postal system to deliver catalogues to its customers two times a year; to deliver its products; it used either the postal system or a common carrier. The business disputed Illinois's levy of its use tax upon the goods delivered to Illinois customers because its only connection with the state was by common carrier and mail. The State of Illinois argued that Bellas Hess had established a minimal connection with Illinois, and should therefore be subject to the law that required the collection of Illinois' tax. Under the relevant Illinois statute, any 'retailer maintaining a place of business'<sup>76</sup> in the state was required to collect the tax. That clause was further defined to include a retailer that was 'engaging in soliciting orders within this State from users by means of catalogues...whether such orders are received or accepted within or without this state'. Illinois asserted that it had provided a market for Bellas Hess to exploit, and Bellas Hess therefore owed Illinois this collection duty. The Supreme Court held that the levy violated the Dormant Commerce Clause because the 'Constitution requires 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.'" Thus, it held that the Due Process Clause and the Commerce Clause required that the seller maintain some sort of presence in the taxing state and the Court made note of the distinction between the taxpayer's physical presence in the state and a presence established solely by common carrier or through US mail or common carrier was insufficient.

The Supreme Court held in *Complete Auto Transit v. Brady*<sup>77</sup> that a tax imposed by a state must meet the following four-prong test to withstand Commerce clause scrutiny. The tax must: (i) apply to a taxpayer with a 'substantial' nexus with the taxing state; (ii) be fairly apportioned; (iii) not discriminate against interstate commerce; and (iv) be fairly related to the services provided to the taxpayer by the state. To date, the majority of litigation arising out of the *Complete Auto Transit* test has focused on the definition of the substantial nexus requirement leading to the creation of the physical presence requirement as discussed in *State of North Dakota v. Quill Corp*<sup>78</sup>. In this case, the Supreme Court declined to eliminate the physical presence test and adhered to the rule that taxpayers had been relying on for 25 years: that physical presence with a state was required before taxation could occur. *Quill* was a mail-order seller of office supplies and equipment, with no physical presence in North Dakota. The State imposed a use tax collection obligation on *Quill*, claiming that *Quill* was a 'retailer maintaining a place of business' in North Dakota. The state acknowledged that *Quill* did not meet the physical presence requirement of *Bellas Hess*<sup>79</sup>, but argued that it did have a significant economic presence in North Dakota, sufficient to require *Quill* to collect tax on items sold into North Dakota.

The North Dakota Supreme Court agreed that *Bellas Hess* was obsolete, based on the changes in society and the mail-order industry since 1967. The *Quill* Court indicated that the Due Process analysis strayed from the physical presence requirement, speaking more to a minimal connection that seemed to embrace North Dakota's economic presence argument. While the Due Process and Commerce Clauses are closely related in their impact on state taxing jurisdiction, *Quill* notes that, because they promote

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<sup>76</sup> 120 Ill. Comp. Stat. 439/2 (West 1965)

<sup>77</sup> *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977)

<sup>78</sup> Supra Note 74

<sup>79</sup> Supra Note 75

disparate goals, different nexus standards apply under each clause<sup>80</sup>. Due Process Clause physical presence is based on whether a taxpayer's connections with a state are substantial enough to legitimate that state's exercise of power over him<sup>81</sup>. By analysis this requirement is satisfied if (i) there is sufficient and purposeful direction of the taxpayer's activities aimed at a state's residents; and (ii) there is rational relationship between the tax imposed and the benefits the taxpayer received through access to the taxing state's market<sup>82</sup>. Therefore, since *Quill* had directed its activities towards North Dakota with an intention to profit there from, under a pure Due Process analysis the tax was fairly imposed. However, while physical presence is not required under the Due Process clause, it is still required under the Commerce clause. In a vain attempt to prevent future confusion, the Court explicitly stated that '*a [out-of-state seller] whose only contact with the taxing State is by mail or common carrier lacks the 'substantial nexus' required by the Commerce clause.*' The Court specifically upheld an important part of its ruling in *Bellas Hess* by emphasizing the 'continuing vitality of *Bellas Hess*' sharp distinction between mail-order (sellers) with a physical presence in a taxing state' and those without such a physical presence. Thus, since *Quill* did not have the requisite physical presence, North Dakota's tax was unconstitutional as a restriction on interstate commerce and a violation of the dormant Commerce clause. The physical presence standard remains in force, and is the standard applied currently to all remote sellers, Internet sellers included. But defining exactly what qualifies as physical presence has proven to be a formidable task. The Supreme Court in *Quill* noted that a 'few floppy diskettes' did not rise to the level of physical presence, but did not offer much beyond that. However the Supreme Court did suggest that Congress has the power to impose uniform state tax rules on the states, and acknowledged that 'Congress is free to decide whether, when and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes'.<sup>83</sup>

In reality as the task of identifying physical presence becomes far more nebulous, and the only clear rule to emerge from the discussion is that *any physical connection*, no matter how slight, could equate to physical presence<sup>84</sup>. However without a clear definition of what qualifies as physical presence, it will be difficult to apply physical presence standard to e-commerce sellers with sales activity across the nation remains largely unanswered.

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80 The Commerce Clause serves to promote a stable national economy, while the Due Process Clause serves to insure notice and fair warning to the taxpayer

81 Supra Note 74 at p 312

82 Supra Note 74 at p 308

83 504 US 298 at p 318 (1992)

84 *Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue*, 483 U.S. 232, (finding nexus based on the permanent presence of a representative in state) as cited by Silhan, Sidney s. (1999) 'If It Ain't Broke Don't Fix It: An Argument For The Codification Of The Quill Standard For Taxing Internet Commerce', at p 13.

# **Chapter- 4**

## **RELEVANCE OF E-COMMERCE FOR TAXATION**

### **INTRODUCTION**

Taxation is clearly part of a political economy. Tax principles naturally involve ethical and political questions. It is the principle mean by which governments can attempt to redistribute wealth and bring about social change through various social policies (Lewis, 1992). Both equity and responsibility in government demand that those who consume government services should pay for them that, to the extent possible, there be a close correspondence between taxes paid and benefits of public services.

#### **4.1 PRACTICES AND OBJECTIVES OF TAX POLICY**

Tax scholars use criteria of 'efficiency' and 'equity' in order to evaluate the appropriateness of a particular tax policy choice. Efficiency concerns include the desired neutral tax treatment of comprehensive forms of economic activity in order to avoid welfare-reducing market distortions, ease of tax administration in order to promote tax collection, and low compliance costs for businesses in order to ensure that economic activity is not unduly discouraged. Equity concerns involve considerations such as fairness among similarly situated individuals (horizontal equity) and fairness among individuals with different economic circumstances (vertical equity).

Modern OECD economies have fundamental economic and social objectives that require public spending. This in turn must be financed through taxation. However, because taxation inevitably impinges on most aspects of economic activity, careful consideration must be given to its design. Three features of taxation are especially important: *First*, tax law should be simple to enable taxpayers to better understand the tax consequences of their economic decisions and it should not influence their economic decisions. That is, taxpayers should not be unduly encouraged or discouraged from engaging in certain activities or taking certain courses of action primarily due to the effect of the tax law on the activity or action. *Second*, the distribution of taxation's impact across the population raises issues of equity, or fairness, which must be given substantial weight even if it entails costs in terms of economic efficiency. *Third*, the practical enforceability of tax rules and the costs arising from compliance are important considerations; the more so since these are both affected by, and have implications for, the efficiency and public perceptions of the fairness of tax systems (Noord, and Heady, 2001). From an overall policy perspective, perhaps the best tax system is one that matches the benefits received with the costs of the system, providing the greatest utility to citizen taxpayers who, through political measures, can determine the desired amount of public services they wish to see funded.

##### **4.1.1 EFFICIENCY CONSIDERATIONS**

Economic efficiency is about maximising economic output given the resources available to the community. If the only concern were to minimise efficiency losses associated with taxation, taxes generally should be designed to leave economic behaviour unaffected. While such a tax system would avoid distortions in economic behaviour, it would be highly unlikely to yield sufficient revenues to fund socially useful expenditure without producing substantial inequity. A more useful guideline is that the tax system should be as 'neutral' as possible, i.e. minimise discrimination in favour of or against any particular economic choices. According to Noord and Heady (2001) "*as a rule of thumb, in the absence of compelling considerations to the contrary, improvements in efficiency can be achieved by: (i) broadening tax bases by eliminating exemptions and special regimes; (ii) flattening rate structures; and (iii) integrating or aligning different tax rate structures to avoid arbitrage opportunities*".

Although an efficient tax system is desirable, it is not the only criteria by which tax systems are judged. Indeed, equity in the tax system is very important. People want tax systems to be fair at least as much as they want them to be efficient. When equity goals are similar to efficiency goals, no conflict arises in the formation of tax policy, but, when the, goals of equity and efficiency conflict, as they often do, normative judgments must be made (Holcombe, 1999)<sup>1</sup>. The next section discusses some generally accepted principles of equity in taxation.

### 4.1.2 EQUITY CONSIDERATIONS

When dividing the principles of taxation into equity and efficiency issues, the efficiency issues tend to be more straightforward because they deal with the facts about the effects of taxation. As discussed before an efficient tax is one that minimizes the excess burden of taxation, that has low compliance costs, and that is easy to monitor and administer. Equity issues, on the other hand, are inherently normative in nature. This implies that there are no indisputable principles of tax equity in the same way that there are with regard to efficiency. Nevertheless, there are a number of generally accepted principles of tax equity. Because in the real world citizens collectively choose their tax policies, and because people want their tax systems to be fair, equity issues are at least as important as efficiency issues in the determination of tax systems.

Two of the most important principles of tax equity are the 'benefit principle' and the 'ability-to-pay principle'. According to the benefit principle, people should pay taxes in proportion to the benefits they receive from government output. This principle has obvious appeal from an equity standpoint. It seems only fair that people should pay for the benefits they receive and, conversely, that people should not be forced to pay for benefits that go to others. The benefit principle, in effect, views a tax as the price that is paid for a government-supplied good. Just as it is fair for people to pay for the goods they receive in the private sector, so it is also fair that they pay for the benefits they receive from the public sector. According to the ability-to-pay principle, people should pay taxes in proportion to their ability to pay (Holcombe, 1999).

However, as Holcombe (1999) suggested there is a close correspondence between the benefit and ability-to-pay principles under the presumption that the demand for government goods and services is correlated with the income and wealth of citizens. If this is true, then those with the greatest ability to pay also are those who derive the greatest benefits from government expenditures. The argument is worth further consideration, for not only is there a certain logic to it, but it also is an old idea in economics, dating back to Adam Smith. In Smith's classic treatise, *The Wealth of Nations*, originally published in 1776, he said,

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<sup>1</sup> Holcombe (1999) at p 203 chapter-11

*“The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state. The expense of government to the individuals of a great nation is like the expense of management to the joint tenants of a great estate, who are all obligated to contribute in proportion to their respective interests in the estate<sup>2</sup>.”*

In other words, Smith viewed the benefit principle and the ability-to-pay principle as implying similar things about the tax structure. Smith stated that one's benefits from government are in proportion to the income that one receives under the protection of the state but that one's income is also a good measure of a person's ability to pay. However as a general principle, 'ability to pay' has much more appeal, but two main issues arise in assessing the fairness of taxes under the ability-to-pay principle they are the concepts of 'horizontal equity' and 'vertical equity'. The principle of horizontal equity is satisfied when people with an equal ability to pay end up paying the same amount of tax. The principle of vertical equity is satisfied when people with a greater ability to pay end up paying the appropriate amount more than people with a lesser ability to pay. The notion of vertical equity is important to the design of a fair tax code. There is widespread agreement that high-income individuals should pay their fair share of taxes and that low-income individuals should not be burdened with excessive taxation. However, there is less agreement on exactly what a high-income individual's fair share of taxes is and to what degree low-income individuals should be able to avoid taxation on equity grounds. The purpose here is simply to introduce the concept of vertical equity. I will discuss the concept in chapter-7, particularly in conjunction with the consumption tax.

#### **4.1.3 ENFORCEABILITY AND COMPLIANCE**

A tax that is generally seen as unfair or arbitrary in its incidence can generate reluctance among taxpayers to comply. Neutrality is important not only for its favourable efficiency and for horizontal equity effects, but also because it usually helps tax rules to be clear and simple to understand, reducing both the administrative and compliance costs of taxation. Evidently, the relationship between equity and neutrality on the one hand and enforceability on the other goes in both directions. It is only by firm and equitable enforcement that a theoretically desirable tax system can be both equitable and neutral in effective terms. Hence providing a better service to taxpayers, particularly the vast majority who wish to pay the correct amount of tax should encourage development of simplified and effective compliance system.

The main thrust of this discussion of tax policy to this point has been to emphasize the importance an efficient and equitable tax system. An inefficient tax code with a large excess burden hinders the productivity of the economy, which means that there is less output for everyone, and everyone is potentially worse off. While most individuals would accept that both efficiency and equity are desirable in a tax system, it may not be possible to achieve both. An efficient tax system may not necessarily be considered fair and one that is considered equitable may not be efficient. The challenge in this case is to establish the

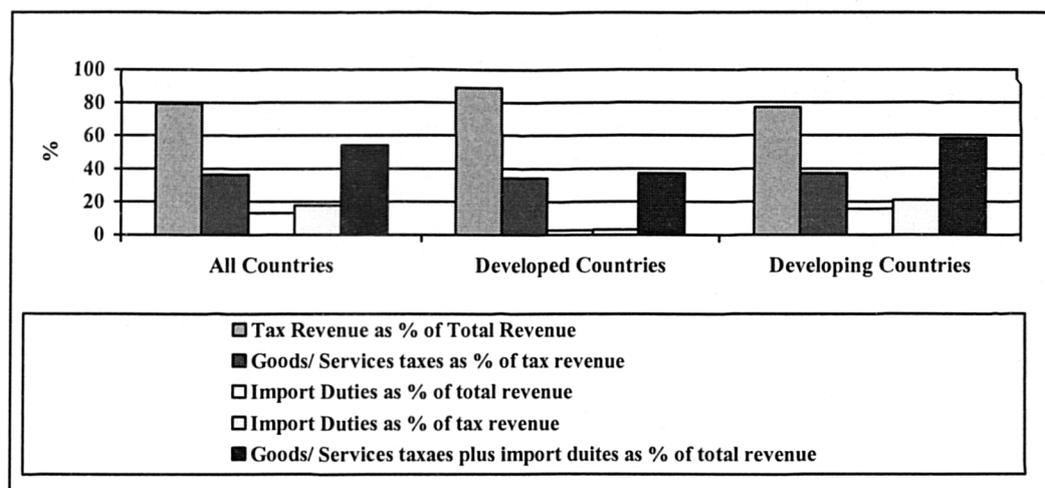
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<sup>2</sup> Adam Smith, *The Wealth of Nations* (New York: Modern Library, 1937, originally 1776), at p 777

tax structure that gives the best trade-off between two. Therefore, a complete understanding of tax policy requires knowledge of the principles of equity and efficiency in taxation, as well as an awareness of the political environment in which tax policy is formulated. If generally agreed upon principles of tax equity it can be identified, and if those principles in a consistent way can be applied to the tax system, then it is possible to produce a tax system that people will agree is fair.

**4.2 TAXES AS SOURCE OF REVENUE**

Data from government finance statistics shows that taxes are the principal source of government revenue, accounting on a verage for a bout 80 % of total revenue (all countries). Domestic taxation of goods and services makes up the largest share in tax revenues (36.5 %)<sup>3</sup>. Revenues from import duties account on average for 13.2 % of total revenue and 17.5 % of tax revenue. Major differences exist between developing and developed countries: for the developing countries import duties as a share of total government revenue are 15.8% (compared with 2.6% for developed countries) and as a share of tax revenue 21.2 % (compared with 3% for developed countries<sup>4</sup>). The combined tax revenues from goods, services and those from imports account for 54% of tax revenues (all countries), or 58.3% of developing countries' and 37% of developed countries' tax revenue (Teltscher, 2000)<sup>5</sup>. These forms of taxation make up a major source of government revenue<sup>6</sup> (Fig 4.1).



**Figure 4.1: Government Revenue Shares.**

Source of Data: International Monetary Fund Government Financial Statistics Year Book 1999

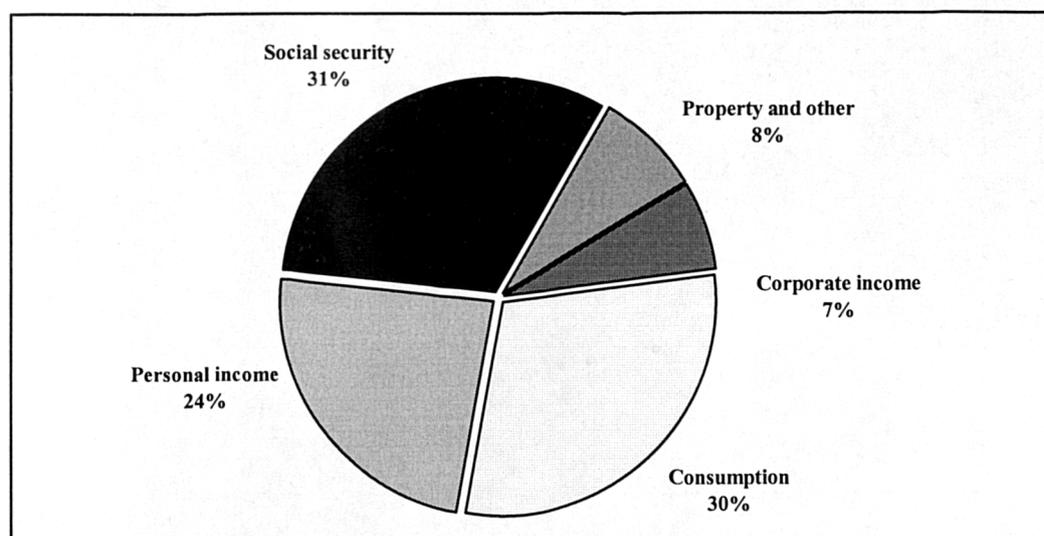
3 Mainly sales and value added taxes

4 In the case of the EU, individual member countries do not report revenues from import duties (some report very low values). This is because EU import duties are directly passed on to the EU common budget as a traditional own resources payment, and only 10% is retained by the importing country (this share increased to 25 % as of 2001). Therefore, the calculations of EU member States' import revenues are based on their individual contributions to the EU budget (European Commission, 1998)

5 Teltscher (2000) at p 1

6 Other important sources not considered here are income taxes and social security contributions.

Income taxes generate about a third of total tax revenue in developing countries. Therefore, they play a much less important role in developing countries than in developed countries where they generate a large proportion of total revenue. Data on the ratios of tax revenue to gross domestic products (GDP) for a number of developing countries for two years, 1978 and 1988 show that most developing countries collect tax revenue that ranges between a higher ratio of 30% and a lower ratio of 10% with an average of around 18% of GDP (Tanzi, 1999). The distribution of tax revenue among major taxes for OECD and the European Union shows that the vast bulk of tax revenue, *i.e.* over 80% comes from three main sources: income taxes, taxes on goods and services, and social security contributions (other payroll taxes are zero or very small in most countries). The European Union relies more on consumption taxes and social security contributions and less on personal income tax than the OECD average. The VAT is a critical source of tax revenues throughout the European Union. The EU countries generally derive about 30% of their overall tax revenue from taxes on domestic goods and services (mainly VAT). In addition, VAT extra charges contribute 45% to the EU Community budget (supplemented by customs duties and other contributions). Effective tax rates on consumption in the EU area are, on average, higher than in most other OECD countries. This not only reflects a higher tax to GDP ratio but also a tax mix relying heavily on consumption taxes (Fig 4.2, 4.3, and Table 4.1).



**Figure 4.2: Per cent share of total tax revenue (European Union)**

Source: OECD, Revenue Statistics, 1965-1999

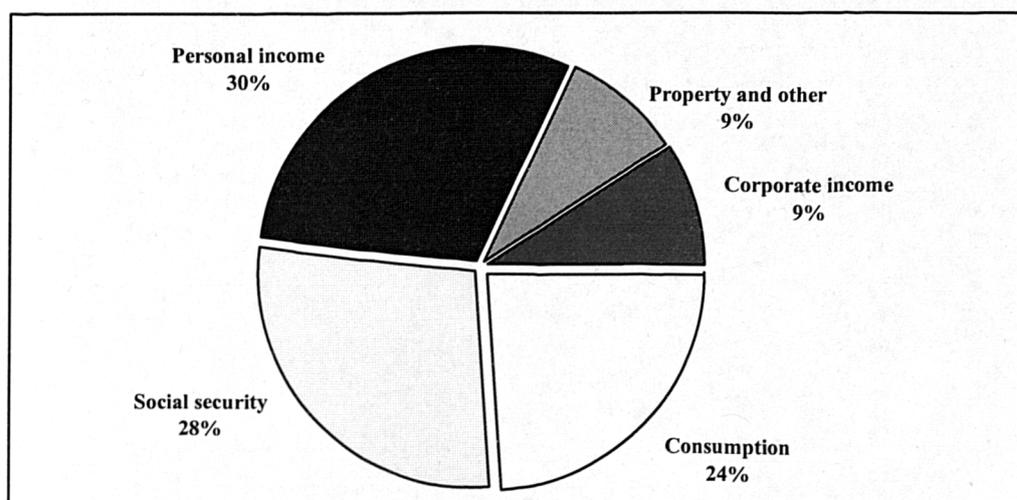


Figure 4.3: Per cent share of total tax revenue (OECD Countries)

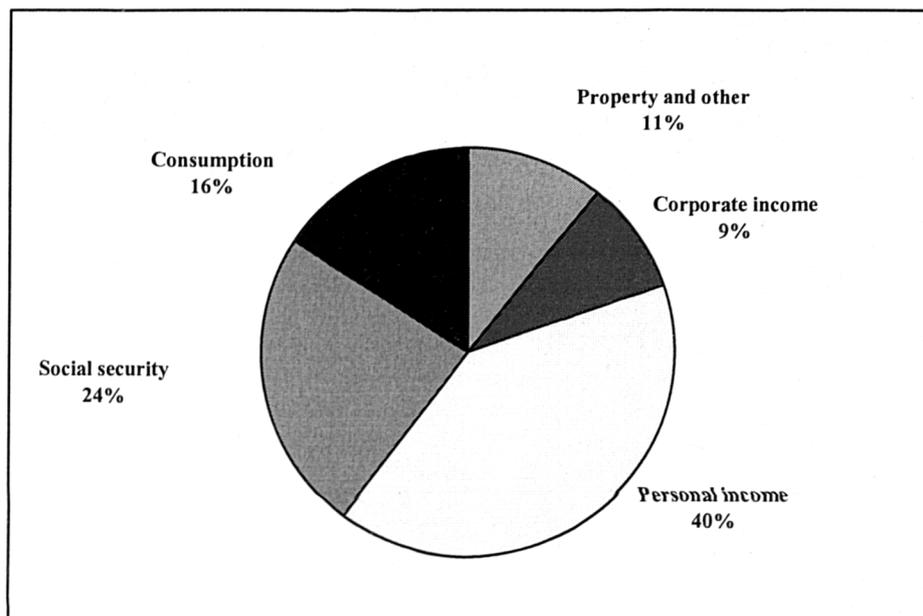
Source: OECD, Revenue Statistics, 1965-1999

	1965	1970	1975	1980	1985	1990	1995	1998	1999
<b>OECD</b>									
Unweighted average	25.8	28.9	31.1	32.1	33.8	35.0	36.1	37.0	37.3
Weighted average	23.1	25.4	26.7	28.3	29.1	30.3	31.9	32.8	33.0
<b>European Union</b>									
Unweighted average	27.8	31.2	34.1	35.8	38.6	39.2	40.1	41.7	42.1
Weighted average	29.1	31.4	33.4	34.6	36.8	37.7	39.4	40.3	40.7

Table: 4.1 Total tax revenue as percentage of GDP

Source: OECD Revenue Statistics, 1965-1999

In contrast, the United States collects a larger share in personal income tax and property tax but a smaller one in consumption taxes and social security (Fig 4.4).



**Figure 4.4: United States Revenue Shares.**

**Source of Data: Source: OECD, Revenue Statistics, 1965-1999.**

State and local governments in the United States rely on sales taxes for financing the services they provide. The taxes have typically yielded about one-third of state tax collections (far more than the contribution for any tax other than the personal income tax) around 10% of local government tax revenue (a distant second to property taxes but more than twice the revenue from any other tax), and about one-quarter of combined state and local tax revenue (U. S. Bureau of Census, 2000). From fiscal 1947 to fiscal 1998, general sales taxes produced more revenue than any other state tax. However, the \$159 billion they produced in fiscal 1998 was roughly two billion dollars less than was produced from individual income taxes. State sales tax bases have been declining relative to state personal income for many years.

### 4.3 NATURE OF E-COMMERCE AND TAXATION

Discussion in the chapter-3 showed that existing taxation systems have developed in an economic environment characterised by the exchange of tangible goods and personal services. However the growth of global electronic information and communication networks is shifting in favour of intangible goods and electronically provided services where suppliers are need not to be present at the point of sale. Exactly the same book, computer, software, or automobile (or other tangible product) could be bought from a Web site or from a local bookstore, computer outlet, or car dealer (or other retail outlet). Similarly, software, music, and movies delivered on-line are quite nearly perfect substitutes for the same products delivered in tangible forms. Perhaps the most important feature of e-commerce is the ease with which shoppers can gain information and the competitive pressure on price. Whereas prior revolutions either drove prior technology to extinction or niche markets (the telephone and telegraph; printed books and illuminated manuscripts) or

created sufficiently different products that competition between the old and the new technology was relatively limited (television and drive-time radio; TV news coverage and printed news media), the digital revolution is creating competition between technologies that deliver essentially the same products in different ways. What, then, are the attributes of e-commerce that have significant implications for taxation?

Professor Hellerstein described the problem as:

*"The new technology and the concomitant reconfiguration of telecommunications and related industries play havoc with traditional standards for determining jurisdiction to tax; the sourcing of income; the nature, value, situs, and timing of sales; the classification of property and taxpayers; and the collection of taxes<sup>7</sup>".*

Jeffrey Owens, Head of Fiscal Affairs for the OECD, has identified six characteristics of the Internet that will influence the operation of tax systems.<sup>8</sup>

- The ability to establish public and private global communications systems, which are secure and inexpensive to operate. The opportunities that this opens up for new forms of commercial activities will not be limited to large companies. Small and medium size enterprises will find it easier to engage in international commerce. Start-up capital requirements on the Internet are typically very low. This, in turn, will lead to a rapid expansion in cross border activities.
- The process of 'disintermediation' whereby the Internet will eliminate or substantially reduce the need for intermediaries in the sale and delivery of goods and services, and in the provision of information. *Commerce, which uses the Internet, requires a small number of distribution, sales representative, broker, and other professional intermediaries.* Already it is possible for a producer of software to sell and to deliver its products directly to the final consumer. Similarly, an airline company can deliver tickets directly to passengers. Financial and other information may become available without the intermediation of banks and other financial institutions.
- The development of encrypted information that protects the confidentiality of the information transmitted on the Internet. Whilst it is possible to detect a message sent by one person to another over the Internet, encryption generally precludes understanding the content of the message.
- An increased scope for the integration of business functions e.g., design and production. Private Intranet networks are now widespread in Multinational Corporations (MNE's). OECD estimates that at least two-thirds of Internet transactions take this form. This development produces a closer integration of transactions within an MNE and makes it increasingly difficult to separate out the functions carried out by related enterprises. This integration may also produce a dramatic synergistic effect the sum of the parts being much less than the integrated whole.

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<sup>7</sup> Hellerstein (1997)

- The Internet provides greater flexibility in the choice of the organisation form by which an enterprise carries out its international activities.
- The Internet has led to a fragmentation of economic activity. The physical location of an activity, whether in terms of the supplier, service provider, or buyer of goods or user of the service, becomes less important and it becomes more difficult to determine where an activity is carried out.

Owens' observations remain as true today as they were when he made them five years ago, even though 1997 may seem like the Dark Ages by the standards of Internet time<sup>9</sup>. I discuss here the following six unique characteristics of e-commerce that cause major concern for taxation: borderless commerce, the emergence of digital commerce, the 'hollowing out of the corporation', and the explosion of real-time transactions and the revolution of new business models.

#### **4.3.1 BORDERLESS COMMERCE**

Most national tax systems as well as the international tax regime on which many of these systems are based assume that commercial activities can be linked to a particular territory. E-commerce challenges this assumption because it is inherently non-territorial. This disjuncture between the geographical foundations of modern taxing systems on one hand and the territorial character of e-commerce on the other is at the heart of the challenge that e-commerce poses to taxation. Cross-border transactions have historically been one of the most problematic areas of taxation. The process of dis-intermediation, in which remote vendors sell directly to customers in other jurisdictions without the buffer of a wholesale distributor or retail outlet, will result in hundreds of thousands of entities dealing with taxes in additional states or countries for the first time. This will expand disputes of both business tax compliance efforts in multiple new foreign jurisdictions and nexus and jurisdictional disputes over which states or nations can impose income or transactional taxes on e-commerce vendors.

#### **4.3.2 DIGITAL COMMERCE**

The ability to deliver the same goods and services in a variety of competing ways changes the nature of competition and places a high premium on economic neutrality and equity in tax policy. There are wide varieties of goods and services that can be digitised or otherwise transferred electronically to customers without the need of more physical delivery. The absence of tax rules adaptable to the digital economy will cut across both direct (income) and indirect (transactional) tax systems.

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<sup>8</sup> Owens (1997) Commerce  
<sup>9</sup> Hellerstein (2001)

#### 4.3.3 THE 'VIRTUAL' CORPORATION

The Internet is also accelerating the trend toward "Virtual" corporations with narrowly defined core competencies. In the information age, there is less need for vertical integration. Companies are more likely to narrowly define their core competencies and leave manufacturing, distribution, fulfilment, customer service, and other functions to third parties. In part, this is because of the ease with which companies can enter into joint ventures, partnerships, outsourcing agreements and other affiliations to bring products to market. For instance, Cisco Systems is primarily a virtual corporation. Cisco Systems sells many of the routers, circuits and other equipment used to construct the infrastructure of the Internet. Over three-quarters of all Cisco Systems, product orders are made online. Over two-thirds of all Cisco Systems manufacturing is outsourced to other companies. As a result, for a large percentage of its product sales, no Cisco employee ever meets either the customer or the actual product involved in a transaction. An even more dramatic example of the virtual corporation is *eMachines*. This personal computer reseller sold 1.7 million computers globally in 1999, producing over US\$1 billion in revenue. Incredibly, the company used only 20 employees to conduct its business, relying on other entities for virtually all of its operational functions.

With the narrowing of core competencies, e-commerce businesses will frequently have more flexibility to relocate (or initially locate) their property and payroll in jurisdictions with more favourable income tax rules and rates. It is far easier to shift the location of computer servers, headquarter employees, or information technology personnel than it is to move a round large factories. Thus, the emergence of the virtual corporation is going to put pressure on tax laws particularly in the income tax arena to develop new rules for apportioning the income of more mobile and dynamic businesses. In a complementary development, the e-commerce also places a premium on intangible values (such as brand names and customer information), leading to more tax compliance, planning, and litigation over the value and location of such intangibles.

#### 4.3.4 REAL-TIME COMMERCE

The Internet also facilitates a significant increase in real-time, paperless transactions. This trend is likely to enhance the momentum toward tax compliance reengineering and automated tax solutions for transactional taxes. It also will increase the pressure on taxing authorities to simplify the substantive and procedural tax rules to make an automated system more workable and less costly. During the 1990s, the growing interest in the automation of sales and use tax or VAT compliance was part of a larger movement toward the use of enterprise resource planning (ERP) software to automate corporate-finance, distribution and other operational functions. The explosion of e-commerce and the growth of Internet-based transaction processing for both business-to-business sales and business-to-consumer sales will accelerate the creation

of a less paper-oriented environment in which electronic databases largely supplant filing cabinets filled with sales invoices and purchase orders.

#### 4.3.5 CHANGING BUSINESS MODELS

The Internet is also causing a revolution in business models that is creating new and challenging issues for state, federal, and international tax systems. The Internet is characterized not just by remote selling but also by a range of evolving business models such as online auctions, reverse auctions, virtual communities, infomediaries, aggregators, and brokers. Traditional industries such as automobiles, clothing, book publishing, and pharmacies are being turned upside down by the potential of online retailing to replace conventional store purchases. Many manufacturers are being transformed into retailers; many conventional intermediaries such as wholesalers and distributors are disappearing or being replaced by new Web-based intermediaries. These business models are significantly altering the landscape of interactions between suppliers, sellers, and buyers creating many new tax issues. For instance, gift certificates are currently an \$11 billion market in the United States. Before the Internet, gift certificates were primarily purchased at retail outlets. In the last two years, however, a number of Internet start-ups such as GiftCertificates.com and Giftpoint.com have begun to build an online marketplace for gift certificates. These entities buy the gift certificates from retail outlets at a discount and resell them over the Internet. The emerging business models for gift certificates and gift giving raise new and difficult tax issues regarding the identity of the actual retailer, the sourcing of consumption, the classification of the good or service sold and the relevant sales price for transactional tax purposes. As the discussion in this Section makes clear, the problem is not merely one of changing rules that no longer make sense, taxation of e-commerce also faces technological constraints. According to Professors Abrams and Doernberg:

*“What may be a sound rule from a tax policy perspective may be totally unworkable in light of available technology. Perhaps the most significant implication of the growth of electronic commerce for tax policy may be that technology rather than policy will determine the tax rules of the 21st century.”<sup>10</sup>*

#### 4.4 NEED FOR TAXATION OF E-COMMERCE

International tax regimes are ‘sets of implicit or explicit principles, norms, rules and decision-making procedures around which actors’ expectations converge in a given area of international relations’.<sup>11</sup> A general theme in tax research is how the necessary tax revenue to support the public services can be raised in the most efficient and equitable way. The debate about e-commerce taxation divides into two primary groups. The first group, the pro-taxation group, believes that e-commerce should be taxed just like regular commerce. Arguments for taxing e-commerce are based on equity, economic neutrality, revenue (or lower tax rates), and simplicity of compliance and administration. *First*, failure to impose the tax on online

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<sup>10</sup> Abrams and Doernberg (1997)

<sup>11</sup> Krasner (1982) at 1 as cited in Roland Paris (2001) at p 3

purchases would cause significant revenue losses for state and local governments. *Second*, if e-commerce is given a no-tax status, then businesses can locate themselves in states where there is no sales tax or VAT (and still serve almost all of their audience online) for electronic purchases, thus making the loss of tax revenues a bigger problem. Differential taxation can also keep businesses from adopting the best business practices. In the case of companies with both traditional and online operations, the need to avoid nexus may prevent some otherwise desirable business practices. For example, in order to prevent nexus, 'Barnes and Noble' stores may not be able to accept returns of merchandise purchased from its online sister company. Companies may be required to maintain separate call centres and warranty and repair operations for their traditional and online customers. Companies operating only through e-commerce may need to avoid locating warehouses in the best sites, building demonstration centres for their products, in order to prevent establishing nexus. *Third*, allowing tax exemption for electronic goods and services that are identical to goods and services purchased in traditional stores is not fair, e.g., not taxing an electronic book that is downloaded directly online while taxing the hardcopy of the same book sold in a store. *Fourth*, it is also unfair to consumers when their tax liability depends on how they buy a good rather than how much they buy. Especially since mostly the richer consumers have access to e-commerce services, banning taxes on electronic transactions allows the richer community to pay less consumption taxes while the poorer part of the community still has to pay VAT or sales tax. Many studies have found the sales tax or VAT to be regressive against current income, meaning the percentage of income paid in sales taxes or VAT falls with income<sup>12</sup>. The evidence indicates that ownership of computers and e-commerce access by low-income households is much below that for high-income households. People with incomes above \$75,000 are about six times more likely to have a computer and about 10 times more likely to be online than those with incomes from \$10,000 to \$14,999<sup>13</sup>. This digital divide can result in uneven taxation that disadvantages low-income households in effect this means even more regressive sales tax or VAT. *Finally*, some seem to believe that e-commerce should receive preferential treatment, in order to encourage its development. There are several problems with this view, which is reminiscent of 'infant industry' arguments for tax incentives often heard in developing countries. There is no evidence that e-commerce needs preferential treatment. E-commerce is growing rapidly and is likely to continue to do so, with or without preferential tax treatment<sup>14</sup>. The situation commonly found in developing countries contemplating tax incentives is vastly different from the present situation in one important respect. In developing countries, there is generally no competing local economic activity to be harmed by the tax-motivated development of new tax-preferred industries. By comparison, much of e-commerce does compete with local vendors who would be disadvantaged by preferential tax treatment of e-commerce.

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12 Fox, William F (1998)

13 This estimation is based on study conducted by National Telecommunications and Information Administration and U.S. Census Bureau, U.S. Department of Commerce using population surveys for the year 2000 as cited by Prof William Fox in 'Taxing E-Commerce: Neutral Taxation is Best for the Industry and the Economy'

14 For detail discussion on Growth of E-Commerce see chapter-2

On the other hand, believers of anti-taxation argue that Internet has created many jobs by moving retailing to the net. Among these jobs, they count trucking and package-delivery sectors. They also argue that by lowering the cost of products for the consumer, e-commerce allows the consumer to buy more things, thus benefiting a wider number of manufacturers. In addition, taxing the e-commerce the same way as conventional businesses brings about other concerns and complications, because: *First*, due to Internet, many small businesses are now able to serve consumers outside of their area. Imposing taxes on e-commerce will keep these businesses from going on the net resulting in huge losses for these businesses as well as the economies they support. *Second*, the opponents of e-commerce taxation commonly argue that because the Internet has had such a profound effect on productivity, there is no need for states to collect the revenues on these transactions. Internet has been the driving force of the economy in many countries and imposing taxes on e-commerce would result in slowing down its growth, costing the governments huge revenues in the end. Given the future higher revenues expected from e-commerce, a tax ban on e-commerce can be viewed as a reasonable government subsidy for a developing industry. *Third*, the existing tax laws are inappropriate for the Internet due to the electronic and border-spanning nature of the Internet. Serious modifications and different enforcement mechanisms are necessary in order for these laws to work for electronic marketplace. *Finally*, some advocates of exempting taxation e-commerce have adopted a theory advanced by the mail order industry that remote vendors should not be required to collect tax because they do not benefit from services provided by the states where their customers are located. This argument and counter-arguments that accept the validity of its basic premise confuse the issue by focusing on services provided to remote vendors, which should be essentially irrelevant. The point is that purchasers pay the sales tax or VAT and it is to them that states provide services; the remote vendor would merely collect the tax. There is no reason to believe that a consumer of a given product consumes fewer state services simply because the product is bought from a remote vendor. Although arguments for both for and against taxation exist, the important thing is for authorities to understand the Internet and its unique nature as well as its potentials and weak points before a decision is made. Especially, understanding the border-spanning and global nature of the Internet is very important before a global tax agreement is reached. The future lies in developing a system suitable for the digital world of e-commerce, which is simplified in terms of compliance and administration.

### 4.5 JURISDICTION IN ELECTRONIC COMMERCE

#### 4.5.1 INTERNATIONAL PRINCIPLES

*“...The key issue that the Internet poses for tax policy is not so much its potential to create a world without borders but rather to create a world of only borders – a world in which everyone is as responsive to local taxation as people who live on geographic borders”.*<sup>15</sup>

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<sup>15</sup> Goolsbee (2000)

Jurisdictional principles, both personal and prescriptive, originally derived from an assumption about the absoluteness of boundaries and sovereign power within them. Every nation (or, in a federation, every state) was thought to have complete authority to control persons and things within its borders and to lack any authority to control persons and things outside them. The latter rule was a corollary of the first; outside a nation-state's borders was another nation with complete authority over its own territory, foreclosing the exercise of jurisdiction by any other state.<sup>16</sup> The jurisdictional assumptions, then, were grounded in political practicality. Such a system makes critical the physical location of a defendant now the state attempts to assert its authority, *i.e.*, now the defendant is served with process. International law limits a country's authority to exercise jurisdiction in case that involve interest or activities of non-residents<sup>17</sup>. First, there must exist 'jurisdiction to prescribe'. If jurisdiction to prescribe exists, 'jurisdiction to adjudicate and, 'jurisdiction to enforce' will be examined. The foregoing three types of jurisdiction are often interdependent and based on similar considerations (Rice, 2002).<sup>18</sup>

'Jurisdiction to prescribe' means that the substantive laws of the forum country are applicable to the particular persons and circumstances.<sup>19</sup> When a country has jurisdiction to prescribe, it can appropriately apply its legal norms to conduct. Hence, a country has jurisdiction to prescribe law with respect to:

- conduct that, wholly or in substantial part, takes place within its territory
- the status of persons, or interests in things, present within its territory
- conduct outside its territory that has or is intended to have substantial effect within its territory
- the actives, interest, status or relation of its national outside as well as within its territory and
- certain conduct outside its territory by persons who are not its nationals that is directed against the security of the country or against a limited class of another national interests.<sup>20</sup>

'Jurisdiction to adjudicate' means that the tribunals of a given country may resolve a dispute in respect to a person or thing where the country has 'jurisdiction to prescribe' the law that is sought to be enforced.<sup>21</sup> The exercise of jurisdiction by a country is also subject to the requirement of 'reasonability'. States exercise jurisdiction to adjudicate on the basis of various links, including the defendant's presence, conduct, or, in some cases, ownership of property within the country, conduct outside the state having a 'substantial, direct, and foreseeable effect' within the country or the defendant's nationality, domicile or residence in the country. Exercise of judicial jurisdiction on the basis of such links is on the whole accepted as 'reasonable,

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<sup>16</sup> One early exception to this absolute rule, though perhaps not clearly perceived as such, was the recognition of a nation's jurisdiction over its citizens even in their absence. *See Pennoyer v. Neff*, 95 U.S. 714, 723-24 (1877) as cited in Report of the American Bar Association ("ABA") Jurisdiction in Cyberspace Project empanelled in 1998 under the title, 'Transnational Issues in Cyberspace: A Project on the Law Relating to Jurisdiction.' (London Meeting)

<sup>17</sup> Restatement (3rd) of the Foreign Relations Law of the US (1987)

<sup>18</sup> *Ibid* pp 230-231

<sup>19</sup> *Ibid* pp 236- 237

<sup>20</sup> *Ibid*

<sup>21</sup> Restatement 304

reliance on other bases, such as the nationality of the plaintiff or the presence of property unrelated to the claim, is generally considered 'exorbitant'. A country may employ judicial or non-judicial measures to induce or compel compliance or punish non-compliance with its laws or regulations, provided it has jurisdiction to prescribe. Thus, a country may employ enforcement measures against a person located outside its territory if

- the person is given notice of the claims or charges against him that is reasonable in the circumstances
- the person is given an opportunity to be heard, ordinarily in advance if enforcement and
- where enforcement is through the courts, if the country has jurisdiction to adjudicate (Rice,2002).

However, even when one of the foregoing bases of jurisdiction is present, a country may not exercise jurisdiction to prescribe law with respect to a person or activity having connection with another country if the exercise of jurisdiction is unreasonable. Mutual sovereign acknowledgment of the circumstances under which its citizens and domiciliary could be subject to the authority of another state permitted the international system to tolerate *multiple sovereign authority over persons and conduct, but always with the understanding that assertions of such authority demanded justification*. One central tenet of liberty is the right to choose with which government one wishes to associate; to what degree the right to remain unconnected is maintained, and when, how, and to what degree it is renounced, drives much of the law of jurisdiction.

#### **4.5.2 EFFECT OF JURISDICTION ON E-COMMERCE**

The basic principles of jurisdiction as described in the previous section have been essentially geographically based and have therefore been difficult to apply in the context of the e-commerce. A website can be viewed from any place in the world where there is access to the Internet. As a result, geographical location has less significance in the context of jurisdiction. Nevertheless, one critical element of the predictability necessary for e-commerce to evolve profitably and efficiently is businesses 'and consumers' knowledge of what regulatory regimes would apply to the businesses in which they engage and with which they interact. Compliance with the law is simply not possible without an understanding of whose law (or laws) is (or are) applicable. Willing compliance of businesses with that law, of course, will frequently obviate the need to answer a second question, where legal disputes may properly be resolved, which also requires a predictable answer. Decreasing the number of disputes requiring judicial resolution is the goal of all interested parties. However, if a legal dispute arises, it is necessary to determine both where and under what law to judge the conduct of the parties. The discussion of jurisdiction in the Internet context involves, in a simple sense, the question of whether the law should view Cyberspace as a place, a means of communication, or a technological state of mind. How that question is answered, to some degree, affects

how concepts of jurisdiction should be evaluated.<sup>22</sup> When an online purchase is made, either directly or through the intervention of an electronic agent, programmed with the background, assets, and preferences of its human principal/buyer, has the buyer stepped into a new place or simply used a different means of communication, much like a phone, fax or satellite link, to affect that purchase? More specifically, if I order a book online from my home in Liverpool from a seller physically located in California, is it as if the bookseller boarded a plane and delivered the book to me in Liverpool, or is it as if I flew to California to purchase the book off his shelf? Does the 'push' and 'pull' of technology make a difference in how the law should be applied?

The art of determining jurisdiction has traditionally been viewed, as an arcane exercise involving the question of where someone can be sued and whose laws should be applied. While understanding where one may be hauled into court is worthwhile, other jurisdictional issues in Cyberspace are frequently far broader and important. For example, when an online distributor of financial products in Dresden, Germany sells those products to a purchaser in Denver, there are jurisdictional questions that both parties may be interested in beyond the question of where one party may sue the other. Where does the seller reside for purposes of organization, franchise and community responsibility purposes? Whose laws apply to such Cyberspace solicitations, advertisements, and sales transactions? Who taxes the business and the transaction? How are the transaction's terms enforced? Raising other technologically related possibilities significantly complicates this analysis. In the previous example, if the book are sold online is actually downloaded to the purchaser rather than actually shipping a hard copy of the book, do the legal consequences of that transaction change? Has technology blurred the lines of demarcation between what should be considered a sale of a service and the sale of a product? If an electronic agent is executing decisions for a party in a way that does not necessarily suggest a physical location for the action, how is the jurisdictional analysis affected?

#### **4.5.3 EU APPROACH TO JURISDICTION IN E-COMMERCE**

##### **A. Brussels Convention and Brussels Regulation**

The fundamentals of jurisdiction in European countries are based on statutes or regulations. The Convention on jurisdiction and the enforcement of judgments in civil and commercial matters (hereafter the Brussels Convention)<sup>23</sup> has been the controlling document within EU. It was introduced in Europe after the six original Member States of the European Economic Community sought to:

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<sup>22</sup> Thomas P. Vartanian (2000)

<sup>23</sup> The Convention on jurisdiction and the enforcement of judgments in civil and commercial matters, signed at Brussels, 27 September 1968, OJ L299/32 1968. There is also another almost identical Convention, the Convention on jurisdiction, and the enforcement of judgments in civil and

*"...enter into negotiations with each other with a view to security for the benefit of their nationals the simplification of formalities governing the reciprocal recognition and enforcement of judgments of courts, tribunals and arbitration awards."*

The Brussels Convention was a double convention that provided rules for both jurisdiction and automatic recognition and enforcement of foreign judgments. This Convention created new international private law rules for the Member States who ratified the Convention. In matters between Member States, the Convention replaced rules of jurisdiction including those contained in any bilateral agreements that Member States had with each other. Matters involving states out with the European Community (often referred to as 'third states') were, however, still to be determined by the international private law rules of each Member State (Gillies, 2001). The Brussels Convention provided general and specific grounds of jurisdiction for civil and commercial matters, including provisions for consumer contracts. The Art 2 enables a person domiciled in a Member States to be sued in that State. This Article could be used by consumers who might be unable to meet the requirements of the specific grounds in Article 5, and in particular Articles 13-15. The European Court of Justice had considered the format and definitions of these grounds in detail. The Convention provides specific grounds of jurisdiction in Articles 5, and in particular for consumers, Articles 13 –15. The special grounds of jurisdiction in Article 5 state, inter alia, that:

"A person domiciled in a Contracting State may, in another Contracting State, be sued:  
1. *in matters relating to a contract, in the courts for the place of performance of the obligation in question;*  
3. *in matters relating to tort, delict, or quasi-delict, in the courts for the place where the harmful event occurred;*  
5. *as regards a dispute arising out of the operations of a branch, agency or other establishment, in the courts for the place in which the branch, agency or other establishment is situated*"<sup>24</sup>.

For matters relating to contract, the European Court of Justice has determined that it ought to be given an 'independent meaning'<sup>25</sup>. In the *Peters v ZNAV* (1983)<sup>26</sup>, the European Court limited further the ability of the forum's conflicts rules to be applied. For matters relating to contract, the European Court held that the obligation in question was essentially the basis of the case<sup>27</sup>. The European Court subsequently held that it was for the court of the *principal* obligation to determine the dispute<sup>28</sup>. The provisions of Article 5 could therefore apply to consumer contracts, excluding the provisions for consumer contracts provided for by Articles 13-15. Moreover, Article 5 could be used as a basis of jurisdiction when the provisions of Articles 13 –15 could not be established. For consumer contracts, specifically for the sale of goods on instalment

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commercial matters and known as the Lugano Convention, agreed through the European Free Trade Association that, *inter alia*, amended the Brussels Convention.

24 1968 OJ L299/32.

25 *Peters v ZNAV* (34/82) (1983) ECR 987, followed in *Arcado v Haviland* (9/87) (1988) ECR 1539.

26 *Peters v ZNAV* (34/82) (1983) ECR 987

27 *De Bloos v Bouyer* (1976) ECR 1497, *Custom Made v Stawa* (1994) ECR I-2913

28 *Shenavai v Kreisler* (266/85) (1987) ECR 239, *Union Transport v Continental Lines SA* (1992) I All ER 161 and *Source Ltd v TUV Rheinland Holdings AG and Others*, The Times 28th March 1997

credit terms, we must look at Articles 13-15. Essentially, the rules for jurisdiction in consumer contracts enable the consumer to sue the business in the consumer's own domicile as long as the sale was one based on instalment credit terms. This special ground of jurisdiction was introduced to provide protection of the consumer as the contractually weaker party<sup>29</sup>. The special grounds of jurisdiction for consumer contracts required to be interpreted independently based on the objectives of the Convention<sup>30</sup> (Gillies, 2001). To address the advent of e-commerce in the context of the existing 'Brussels Convention' the EU Commission in 2000 had recommended that jurisdiction should generally be based on the defendant's domicile, but that alternative jurisdictional grounds should be available if there were a 'close link' between the court and the action or if the 'sound administration of justice' would be facilitated.<sup>31</sup> The jurisdiction of the domiciliary country would continue<sup>32</sup>. The place of performance would have jurisdiction over contract actions<sup>33</sup>. In tort actions, jurisdiction would lie in the place 'where the harmful event occurred or there is a risk of it occurring'<sup>34</sup>. Subsequently, the EU issued the 'Brussels Regulation', which took effect March 1, 2002<sup>35</sup>. While the 'Brussels Regulation' does not alter the main structure of the 'Brussels Convention', it effects certain changes that were intended to take account of new technological developments relating to e-commerce. Specifically, the 'Regulation' provided that the courts of the consumer's domicile have jurisdiction over a foreign defendant if the latter "*pursues commercial or professional activities in the Member State...of the consumer's domicile or, by any means, directs such activities to that Member State...and the contract falls within the scope of such activities*".<sup>36</sup> This view of the 'Regulation' expands the range of situations in which the consumer can sue in his or her jurisdiction only if the consumer has been subject to a 'specific invitation' or advertising made in the consumer's state of domicile. In contrast, the 'Brussels Regulation' abandons the requirement of a specific invitation or advertising and instead covers any consumer contract 'concluded with a person who pursues commercial activities in the Member State of the Consumer's domicile...by any means' (Rice, 2002).

The phrase 'by any means' was not inserted as a catch-all (Rice, 2002). Rather, it is specifically intended to reach Internet-based transactions<sup>37</sup>. Under the 'Brussels Convention', a consumer must have performed the acts necessary to conclude the contract in the consumer's own country in order to sue there. As a result, a consumer who has contracted from a different country, or who cannot prove that he or she contracted from his or her domicile, is not entitled to sue in his or her domicile. The effect of the language used in the

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29 Reaffirming *Bertrand v Ott*, where the European Court stated that Article 13 could not be extended to cover the sale of goods between businesses by instalments. Indeed, Article 13 of the Brussels Convention was amended to take into account the issue of consumer protection together with the proposals for the Rome Convention on contractual obligations. See Alan Dashwood, Richard J. Hacon, and Robin C. A. White, *A Guide to the Civil Jurisdiction and Judgments Convention*, Kluwer Law and Taxation Publishers, Deventer, 1987 at p.28.

30 C-89/91 Shearson Lehman Hutton v TVB (1993) ECR I-139

31 EU Proposal, Preamble, point (11)

32 Ibid at Ch. II sec 1, art. 2

33 Ibid at Ch. II sec 1, art. 5(1)

34 Ibid at Ch. II sec 1, art. 2(3)

35 Council Brussels Regulation (EC) (Dec. 22, 2000), Official J. L012, 16/01/2001, p. 0001-0023

36 Art. 159 (c) of Brussels Regulation.

37 European Commission, Explanatory Memorandum to the Proposal for a Council Regulation on Jurisdiction, COM (1999) 348 of 14 July 1999.

'Brussels Regulation' is to remove this limitation and require simply that the contract fall within the scope of the activities directed to the consumer's domicile. Thus, the Brussels Regulation 'equates the offer of goods and services via the Internet with an invitation or advertising by business which 'by any means.....direct their activities towards that Member State...'<sup>38</sup>

Before issuing the 'Brussels Regulation', the EU Commission specifically rejected a proposed amendment that would have defined the concept of activities deemed to be 'directed' toward one or more States. In doing, the EU Commission stated that the proposed definition "is based on the essentially American concept of the business activity as a general connecting factor determining jurisdiction, whereas the concept is quite foreign to the approach taken by the regulation"<sup>39</sup>. The EU Commission intended specifically to reject the US jurisdictional rule that only 'active websites' constitutes doing business in a given jurisdiction<sup>40</sup>. In essence, that 'Brussels Regulation' provided that an unintended effect in member state could be a basis for jurisdiction. Both the 'Brussels Regulation' and 'Brussels Convention' that provide any pre-dispute choice of forum other than the consumer's domicile, if a consumer is dealing with a business, is invalid. The EU Commission was expressly unwilling to allow consumer contracts to contain forum selection clauses that referred disputes to courts other than those in the consumer's domicile<sup>41</sup>. The European Commissioner for Health and Consumer Protection purportedly justified this position as necessary to consumer confidence in doing business over the Internet<sup>42</sup>. The effect is that the consumer cannot, even by consent, be deprived of jurisdictional rights provided by the 'Brussels Regulation'.

The 'Brussels Regulation' was controversial and was the subject of the fierce lobbying during the legislative process by business and consumer groups<sup>43</sup>. Industry groups claimed it would hinder the growth of e-commerce by making small to medium-sized businesses reluctant to set up websites for fear of being subjected to the jurisdiction of the courts of every other country<sup>44</sup>. The Confederation of British Industry (CBI) argued that the 'Brussels Regulation' failed to honour the pledges made by European leaders at Lisbon to promote e-business and, more importantly, does nothing to promote e-commerce in EU or help consumers in an ever more complex world<sup>45</sup>. According to commentators:

*"Whilst previously business had to consciously, solicit contracts with consumers in other countries ( and therefore the Brussels convention could be seen as a right and fair) the Internet has radically altered that way we do business. The Internet, by definition, allows companies to offer their services on a world market without specifically targeting one particular country. Therefore, article 15, which says that if a trader by any means, directs*

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38 Opinion of the Economic and Social Committee on the Proposal for a Council Regulation (EC) on Jurisdiction and the Recognition and Enforcement of Judgements in Civil and Commercial Matters, CES 233/2000-99/1054 CNS (March, 2000)

39 European Commission, Explanatory Memorandum to Amended Proposal for Council Brussels Regulation, COM (2000) 689, Final October 26, 2000

40 Berliri, Marco (2001) referencing *Cybersell, Inc v Cybersell Inc*, 130 F. 3d 414 (9th Cir, 1997)

41 Berliri, Marco (2001)

42 Ibid

43 Ibid at pp 5-6

44 Ibid

45 Hickerson and Taylor (2000) at p 10

*such activities to that Member State or to several countries including that Member State, creates an enormous uncertainty for an online trader*<sup>46</sup>.

The EU Commission has argued that the absence of strong consumer protection principles in e-commerce disputed would not only negatively influence consumer confidence but also affect the unified European market<sup>47</sup>. If consumers who shop online only shop with established enterprises they are familiar with in their own country, it believes that the EU e-commerce sector will be put at a significant competitive disadvantage to the US.<sup>48</sup>

## B. The Hague Convention

Long before anyone was considering the impact of the Internet, the Hague Convention<sup>49</sup> on Jurisdiction and Foreign Judgments in Civil and Commercial matters was first proposed in 1992. Formal negotiations started in 1996 and since then, it has paid much attention to the e-commerce provisions<sup>50</sup>. Hague Conference issued the second draft of its proposed worldwide judgments Convention in June 2001 and the proposed Convention seek to ensure that judgments in 'civil and commercial matters' derived from Contracting States are capable of being recognised and enforced in other Contracting States. Civil and commercial matters were not defined in the draft Convention. However, according to Report of the Special Commission by Nygh and Pocar (2000) such matters were likely to be determined in an 'autonomous manner'<sup>51</sup> and probably subject to a 'liberal interpretation'.<sup>52</sup>

The drafts<sup>53</sup> of the proposed Convention provided rules for the recognition and enforcement of judgments as well as rules of jurisdiction. These rules seek ultimately to facilitate the recognition and enforcement of a judgment in a second country, without that second country having to consider the issue of whether the first country had jurisdiction to adjudicate the matter. In this way, the draft 'Hague Convention' models the 'Brussels Convention' on Jurisdiction and the Recognition and Enforcement of Judgments.<sup>54</sup> The draft 'Hague Convention' differed from the 'Brussels Convention' in a number of respects. *Firstly*, the Brussels Convention applied to civil and commercial matters where a defendant was domiciled in a European

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46 Ibid at p 11

47 European Commission Explanatory Memorandum to Amended Proposal for Council Brussels Regulation. COM (2000) 689, Final October 26, 2000

48 David Byrne, European Commissioner for Health and Consumer Protection, on the occasion of the Annual Conference of the Kangaroo Group of MEP's 18th September 2000, [www.europe.eu.int/comm/dgs/health\\_consumer/library/speeches/speech55\\_en.html](http://www.europe.eu.int/comm/dgs/health_consumer/library/speeches/speech55_en.html)

49 The Preliminary Draft Convention on Jurisdiction and Foreign Judgments in Civil and Commercial Matters was adopted by the Special Commission on 30 October 1999. The text could be obtained in <http://www.hcch.net/e/conventions/draft36e.html>.

50 Meeting in Ottawa on the Hague Convention on Jurisdiction and Foreign Judgments in Civil and Commercial matters, <http://www.cptech.org/ecom/hague-march-2000.html>.

51 Nygh, Peter and Pocar, Fausto (2000) 'The Future Hague Convention on International Jurisdiction and the Effects of Judgments in Civil and Commercial Matters,' Report of the Special Commission, Preliminary Document No.11, by at p 33. The Report is available at <http://www.hcch.net>.

52 Ibid.

53 Released by the Hague Conference in October 1999 and June 2001.

54 The Brussels Regulation

Member State. The proposed 'Hague Convention' has the potential for global application and in certain matters; the defendant does not have to be domiciled in a Contracting State for jurisdiction to be established (with the exception where bases of jurisdiction are deemed to be exorbitant). *Secondly*, in order to facilitate the recognition and enforcement of judgments throughout Europe, EU Member States agreed on a Convention providing rules for both recognition and jurisdiction in civil and commercial matters. The proposed draft Convention appears to mirror that objective as '*technically a mixed Convention...drafted as a double Convention*'.<sup>55</sup> It has been argued that the possibility of reaching agreement on one definitive set of global jurisdiction rules was highly unlikely and unrealistic.<sup>56</sup> After a number of Special Commission meetings, the Hague Conference decided to provide different rules of jurisdiction throughout their draft Convention. However, agreement has not yet been achieved on the extent and content of the jurisdiction rules in the Convention (Gillies, 2002). Indeed, Von Mehren reiterated that:

*'The degree of consensus required for a global convention on jurisdiction and recognition to be successful can only be achieved if its scope is more modest and its provisions more tolerant to differences in practices and values than could any convention largely based on the conceptions, aspirations, and approaches embodied in the Special Commission's Preliminary Draft'*.<sup>57</sup>

Since the Hague Conference's last attempt in 1971,<sup>58</sup> no international organization has sought to propose global rules of jurisdiction and judgment enforcement (Gillies, 2002). In 1992, the United States made a request to the Hague Conference to consider placing on their agenda work for an international Convention on jurisdiction and judgments. The proposals to commence work in this area were accepted and a first draft was published in October 1999 (hereafter 'the 1999 draft'). Nevertheless, for the time being the June 2001 draft remains the Hague Conference's proposed judgments convention. Both the 1999 and the 2001 draft conventions proposed different bases for the application of certain jurisdiction rules. *Firstly*, there are jurisdiction rules that must be applied (subject to public policy grounds) by all Contracting States. These are often referred to as the 'mandatory rules' or 'white list' rules. *Secondly*, there are specified rules of jurisdiction that are not to be applied by the Contracting States to the Convention. These have become known as 'black list rules'. From a practical point of view, these rules are often the grounds of jurisdiction found in some countries that are deemed exorbitant. A well cited example is the United States test of 'doing business'. Such a rule enables a defendant to be subject to the US courts' jurisdiction if it can be demonstrated that the defendant is 'doing business' in that jurisdiction. Recognition and enforcement of judgments obtained by the application of such exorbitant rules would not usually be permitted in other

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55 Arthur T. Von Mehren (2001) 'Drafting A Convention on International Jurisdiction and the Effects of Foreign Judgments Acceptable Worldwide: Can the Hague Conference Project Succeed?' 2001 49 American Journal of Comparative Law 191 at p.199.

56 Examples of the different views held by American commentators on the draft Hague Convention, see Von Mehren, *ibid*, Stephen B. Burbank, 'Jurisdictional Equilibration, the Proposed Hague Convention and Progress in National Law,' 2001 40 American Journal of Comparative Law 203

57 Von Mehren, *ibid* at p.192.

58 Convention on the Recognition and Enforcement of Foreign Judgments in Civil and Commercial Matters, concluded in 1971, hereafter 'the 1971 Convention' <http://www.hcch.net>. Contracting States were still required to enter into their own bi-lateral agreements with each other to give effect to the 1971 Convention. The 1971 Convention was only ever applicable between Cyprus, The Netherlands, and Portugal.

countries on grounds of public policy. The last proposed ground of jurisdiction would give Contracting States the discretion whether or not to apply certain other rules of jurisdiction within their national laws. Not surprisingly, these rules are known as 'grey list' rules. According to the Nygh and Pocar Report,<sup>59</sup> recognition and enforcement of these rules will 'depend on the national law of the State addressed'. A consequence of such rules may be that parties are more likely to consider forum shopping for the jurisdiction most favourable to them.<sup>60</sup> Therefore, the manner in which such rules are approved and adopted into the Convention will ultimately determine whether a Contracting State has jurisdiction over a dispute; secondly, whether parties seek to select the forum on that basis, and thirdly whether the judgment obtained is capable of being recognised and enforced in another Contracting State under the Convention (Gillies, 2002).

The scope of the '1999 draft Convention', contained in Article 1, was to apply to civil and commercial matters, excluding such matters in much the same way as the 'Brussels Convention'. The proposed rules on choice of court were contained in Article 4.<sup>61</sup> The '1999 draft' Article 4 stated that a court would have jurisdiction if this had been agreed between the parties. Indeed, this choice appeared to be 'exclusive' in Article 4. There was also a reference made to the selection of courts in non-Contracting States. Article 4 required courts in Contracting States to either decline or suspend proceedings if the court in the non-Contracting States had not declined jurisdiction. The emphasis of Article 7 of the 1999 draft was that the defendant (i.e. a seller of goods or services) would have to direct activities towards a plaintiff (i.e. an individual buying out with his or her trade or profession; a consumer) by means of publicity. This would be done by means of publicity, namely advertising. Of course, by 1999, many businesses used the Internet as a means of advertising their products and services for sale. The question was whether Article 7 extended to Internet advertising by means of publicity directed towards a Contracting State. Indeed, at the time this

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<sup>59</sup> Nygh and Pocar (2000) at p.30.

<sup>60</sup> Mehren, Arthur T. Von (1994) at p 271.

<sup>61</sup> Article 4 of the 1999 draft Convention provided.

1. If the parties have agreed that a court of courts of a Contracting State shall have jurisdiction to settle any dispute which has arisen or may arise in connection with a particular legal relationship, that court or those courts shall have jurisdiction, and that jurisdiction shall be exclusive unless the parties have agreed otherwise. Where an agreement having exclusive effect designates a court or courts of a non-Contracting State, courts in Contracting States shall decline jurisdiction or suspend proceedings unless the court or courts chosen have they declined jurisdiction.

2. An agreement within the meaning of paragraph 1 shall be valid as to form, if it was entered into or confirmed -

(a) in writing;

(b) by any other means of communication which renders information accessible so as to be usable for subsequent reference;

(c) in accordance with a usage which is regularly observed by the parties;

(d) in accordance with a usage of which the parties were or ought to have been aware and which is regularly observed by the parties to contracts of the same nature in the particular trade or commerce concerned.

3. Agreements conferring jurisdiction and similar clauses in trust instruments shall be without effect if they conflict with the provisions of Article 7,8 or 12.

draft was released, this issue was becoming increasingly significant in similar proposals to replace the Brussels Convention at EU level.<sup>62</sup>

However, the Special Commission did not adopt the text of the '1999 draft' at their meeting in October 1999. Many aspects of the Convention remained unresolved, including which rules should be included in a white, grey, or black list, which jurisdiction rules were deemed to be 'exorbitant' as well as the content and consequences of the rules themselves. In the absence of consensus, further work on the Convention was required. Since then, the proposals have come to the attention of a number of international governmental and non-governmental organizations. Debates on the purpose and content of the draft Convention commenced in earnest. A number of Diplomatic Meetings were held between 2000-2001<sup>63</sup> as well as the first of two Diplomatic Meetings at The Hague in June 2001. In June 2001, the Hague Conference published updated proposals thereby replacing the October 1999 draft. These Diplomatic meetings considered, inter alia, the effect of the proposals on matters involving e-commerce contracts and intellectual property aspects such as copyrights, patents, and trademarks. It became apparent that e-commerce would have to be considered and included in any draft of a proposed global convention on jurisdiction and recognition of judgments for civil and commercial matters.<sup>64</sup> It is submitted that if the draft Convention seeks to provide worldwide rules of jurisdiction, recognition and enforcement of judgments, electronic commerce disputes (whether contractual or tortious) cannot be ignored. The question is to what extent the Convention should provide mandatory rules for electronic contracts (including consumer contracts) and intellectual property disputes and whether Contracting States should be allowed to opt in to the terms of the Convention as they see fit. If the latter option prevails,<sup>65</sup> then the use of such a Convention to assist forum selection might have to be considered as a real threat to its ultimate purpose.

The extent to which the Convention will apply in conjunction with other international and regional instruments such as the 'Brussels Regulation'<sup>66</sup> has, yet to be assessed. For example the provisions for electronic consumer contracts in the final Regulation<sup>67</sup> state that jurisdiction for consumer contracts will be established if the consumer has been targeted by specific advertising or activities directed towards their own jurisdiction under Article 15(1)(c).<sup>68</sup> If the Hague Conference sought to put the issue of e-commerce in the Convention on hold, then at least the corresponding provisions of the 'Brussels Regulation' for

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62 Gillies (2001)

63 Washington (Dec 2000), Geneva (Feb 2001), Ottawa (March 2001), Edinburgh (April 2001).

64 Editorial, 'As E-Commerce is Global it Needs Predictable and Enforceable Solutions: Hague Draft Convention on Jurisdiction and Judgments,' 2002 8(3) *Computer and Telecommunications Law Review*, 55; Dan Svantesson, 'Jurisdiction Issue in Cyberspace What Should Article 7 – Consumer Contracts, of the Proposed Hague Convention, Aim to Accomplish in Relation to E-Commerce?' 2001 5 *Computer Law and Security Report* 318 as cited in Gillies (2002)

65 Now unlikely given the Permanent Bureau's report considered below, *infra* at p. (XX).

66 The Brussels Regulation

67 Gillies (2001)

68 *Ibid.*

consumer contracts (which make reference to contracts conducted on-line) could be assessed during that time (Gillies, 2002).<sup>69</sup>

Whilst the draft proposals, the scope and need for the Convention itself continue to be debated, the inherent difficulties in ascertaining jurisdiction in international electronic commerce and IP matters remain to be addressed. During April 2002, it was reported that the Hague Conference would continue to work on the Judgments Convention project, albeit with a far limited scope with creation of informal working groups.<sup>70</sup> The Permanent Bureau's Summary of the Meeting by Commission confirmed that

*"... the starting point for this informal process will be a discussion of core area of possible grounds of jurisdiction as tentatively identified by the Commission, as well as the existing provisions on recognition and enforcement upon which there is broad agreement."*<sup>71</sup>

From 22-25 October 2002 the informal working group on the Judgments Project held its first meeting.<sup>72</sup> The group published its first report on November, 2002<sup>73</sup>. As decided by the Commission on General Affairs and Policy of the Hague Conference at its meeting from 22-24 April 2002, the informal group explored whether a text could be presented to a Special Commission, to be held in mid-2003, with a sufficient prospect of reaching agreement. The group therefore discussed the desirability of trying to achieve a single text for referral to a Special Commission, with the belief that a unified endorsement from the group would provide the most effective guidance for government delegations. The work of the group follows a 'bottom-up' working method. The first meeting focused on exclusive choice of court clauses in business-to-business (B2B) cases. Possible convention requirements on formal and substantive validity of such clauses were discussed, as well as the possible scope of a rule on choice of court clauses, the relationship with other Conventions, bilateralisation and the applicability or non-applicability of national and/or Convention rules on *lis pendens* and *forum non conveniens*, the problem of personal versus subject matter jurisdiction and the question of interim relief. The group further agreed to meet in order to continue the discussion on choice of court clauses, including non-exclusive choice of court clauses, which might require a different treatment in some respects than exclusive choice of court clauses. However being only

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69 In any event, Recital 28 of the Brussels Regulation states that "No later than five years after entry into force of this Regulation the Commission will present a report on its application and, if need be, submit proposals for adaptation."

70 See the Conclusion for Commission (General Affairs and Policy) of the XIXth Session, April 2002 available at <http://www.hcch.net/e/updates.html>.

71 Ibid.

72 The meeting was chaired by Professor Allan Philip from Denmark and took place at the Permanent Bureau of the Hague Conference on Private International Law in The Hague. The members of the group, representing the global membership of the Hague Conference and a variety of legal systems, are Marie-Odile Baur (European Commission), Paul Beaumont (United Kingdom), Antonio Boggiano (Argentina; apologised for this meeting), Alegría Borrás (Spain), Andreas Bucher (Switzerland), Masato Dogauchi (Japan), Antonio Gidi (Brazil), David Goddard (New Zealand; apologised for this meeting), Jeffrey Kovar (United States of America), Nagla Nassar (Egypt), Gugu Gwen Ncongwane (South Africa), Tatyana Neshataeva (Russian Federation), Fausto Pocar (Italy), Kathryn Sabo (Canada), Peter Trooboff (United States of America), José Luis Siqueiros (Mexico), Sun Jin (China), and Rolf Wagner (Germany). They are participating in their personal capacity

73 Report On The First Meeting Of The Informal Working Group On The Judgments Project – October 22-25, 2002, November 2002, Hague Conference On Private International Law, Andrea Schulz, First Secretary

limited to B2B contract it remains to be seen how effective useful this can be for e-commerce. Whilst international commercial activities certainly need global regulation of jurisdiction, recognition and enforcement rules,<sup>74</sup> after ten years a cohesive desire for such rules still eludes Hague Conference's efforts.

#### 4.5.4 US JURISDICTIONAL PRINCIPLES TO E-COMMERCE

Under the United States Constitution, a court cannot assert jurisdiction over a potential defendant unless the defendant has sufficient "minimum contacts" with the forum to satisfy traditional notions of fair play and substantial justice<sup>75</sup>. These minimum contacts may be some type of systematic and continues contact with the forum, or isolated or occasional contacts purposely directed toward the forum<sup>76</sup> that the defendant have minimum contacts with the forum state. 'Minimum contacts' can be deduced from three aspects. Firstly, the defendant must have purposefully availed himself to the forum state<sup>77</sup>. Specifically, purposeful availment is found when the defendant's action is purposefully directed towards the forum state and shows a substantial connection with the forum state<sup>78</sup>. Secondly, the contact of the defendant with the forum state will be sufficient to confer jurisdiction based on the relatedness of the contact to the cause of action so it is important that the claim arises out of those contacts and thus, is directly related to the defendant's contact. Thirdly, the exercise of jurisdiction is reasonable. The defendant should reasonably expect to be hauled into court there<sup>79</sup>. This could be inferred, for example, if most of the records of the transaction exist within the state.

In *Bensusan Restaurant Corp. v. King case*, the court ruled that the defendant's simple creation of a web site, that was available to any user who can find it on Internet, was not an act of purposeful availment<sup>80</sup>. 'Due process' further requires that maintenance of the suit in the forum state would not offend traditional notions of fair play and substantial justice<sup>81</sup>. The Supreme Court has provided five factors in analysing the fairness, namely, the burden on the defendant; the forum state's interest in adjudicating the dispute; the plaintiff's interest in obtaining convenient and effective relief; the interstate judicial system's interest in obtaining the most efficient resolution of controversies; and the several states' shared interest in furthering fundamental substantive social policies<sup>82</sup>. As interactivity between businesses partners becomes commonplace, the need for physical presence in a state is slowly disappearing. In line with these developments, traditional jurisprudence is evolving as the courts grapple with the new medium (Cohen, 1998).

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74 A fact acknowledged by the Permanent Bureau's Summary of Commission I's meeting.

75 *International Shoe Co. v. Washington* (1945) 326 US 310.

76 *Helicopteros Nacionales de Columbia, S.A. v. Hall*, 466 U.S. 310 (1945)

77 This was refined in *Hansen v. Denckla*, 357 U.S. (1958).

78 *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 475 (1985).

79 *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 297 (1000 S.Ct. 559, 567, 62 L.Ed.2d 490) (1980).

80 *Bensusan Restaurant Corp. v. King*, 937 F.Supp. 310 (S.D.N.Y. 1996). Similar holdings can be found in *McDonough v. Fallon McElligott, Inc.*, 1996 U.S. Dist. LEXIS 15139, No. 95-4037, slip op. (S.D.Cal. Aug. 6, 1996).

In the following cases, the courts found that there was sufficient contact in order to claim jurisdiction. In *CompuServe, Inc v Patterson*, 89 F. 3d 1257 (6<sup>th</sup> Cir. 1996) Sixth Circuit an Internet user from Texas subscribed to a network service based in Ohio. The user “specifically targeted” Ohio by subscribing to the service and entering into a separate agreement with the service to sell his software over the Internet. He repeatedly sent his software to the service in Ohio. The court held that the user had “reached out” from Texas to Ohio and originated and maintained contacts with Ohio so that jurisdiction vested in the Ohio court (Jones, 1999). Should a business be subject to the laws of whatever jurisdiction that a consumer drags its digital message? What are the commercial costs of such a result? In addition, how are such results enforced? A similar set of issues is raised in *Minnesota v. Granite Gate Resorts, Inc.*<sup>30</sup>, which applied the laws of Minnesota to an online gambling business located in Las Vegas, which operated through a server in the country of Belize. The appeal court noted that advertisements placed on the Internet were analogous to a broadcast and to direct mail solicitations, activities that, under the Minnesota long-arm statute, are sufficient for an exercise of personal jurisdiction. Sweeping legal assertions that every transmission viewable in a state is subject to the criminal and civil laws of that state, such as Minnesota has made, are difficult to harmonize, since they essentially mean that each such state regulates the entire Internet. The early cases involving jurisdiction over cyberspace in the US were marked not only by inconsistencies, but also by failure to appreciate the technological realities of the new medium. One example was a decision of the Connecticut federal court in 1996. Inset Systems sues Instruction Set (ISI) in Connecticut for trademark infringement<sup>83</sup>. Even though ISI had no assets in Connecticut and was not physically transacting business there, the district court determined that it has specific personal jurisdiction over ISI in Connecticut. It based its determination on ISI’s use of a toll-free telephone number and the fact that there were at the time 10,000 Internet users in Connecticut, all whom had the ability to access ISI’s website. It found the advertising to be ‘solicitation of a sufficiently repetitive nature to satisfy’ the requirements of Connecticut’s long-arm statute, which confers jurisdiction over foreign corporations on a claim arising out of any business in Connecticut. The court held that the minimum contact test of the due process clause of the Fourteenth Amendment was satisfied, reasoning that defendant had purposefully ‘availed’ himself of the privilege of doing business in Connecticut in ‘directing’ advertising and its phone number to the state, simply because subscribers could access the website. What the Inset court failed to appreciate adequate was that any (just as the Paris Court in Yahoo case failed to appreciate), website can be accessed worldwide by anyone at anytime. Moreover, it failed to give weight to lack of evidence that any Connecticut residents actually had accessed the site or made a toll-free call to ISI. Under the court’s line of reasoning, any website would be subject to jurisdiction everywhere just by virtue of being on the Internet.

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81 *International Shoe*, 326 U.S. 310, 316 [66 S.Ct. 154, 158, 90 L.Ed. 95] (1945).

82 *Burger King*, 471 U.S. at p 477.

*Minnesota v Granite Gate Resorts, Inc*, No. C6-95-7227, 1996 WL 767431 (Minn. Dist. Ct. Dec. 11, 1996), aff’d, 568 N.W.2d 715 (Minn. Ct. App. 1997) and aff’d, 576 N.W.2d 747 (Minn. 1998)

In addition, in 1996, a Pennsylvania federal court delivers the first diction in the US that included an overall analytical framework to test specific personal jurisdiction based on Internet activity. In *Zippo Mfg. Co v Zippo Dot Com, Inc* (Zippo)<sup>84</sup>, the court created a ‘continuum’, or sliding scale, for placing websites, into one of three general categories (i) passive, (ii) interactive or (iii) integral to the defendant’s business. The ‘passive’ website is analogous to an advertisement in Time magazine, it posts information that is generally available to any views, who has no on-site means to respond to the site. Courts ordinarily would not be expected to exercise personal jurisdiction based solely on a passive Internet website, because to do so would not be consistent with traditional personal jurisdiction law. An ‘integral’ website is at the other end of the continuum: it is used actively by the operator to conduct transactions with persons in the forum state, receiving online orders and pushing confirmation or other messages directly to specific customers. In such cases, traditional analysis supports personal jurisdiction. The middle category or ‘interactive’ website falls between passive and integral. It allows a forum-state viewer to communicate information back to the site, by toll-free telephone number, regular mail, or even e-mail. Under *Zippo*, exercise of jurisdiction in the ‘interactive’ context is determined by examining the level of interactivity and the commercial nature of the site. Because in *Zippo* a non-resident California defendant operated an internal website that had commercial contacts with 3,000 Pennsylvania residents and Internet service providers, the court had no difficulty finding jurisdiction.

The *Zippo Dot Com* formulation was subsequently adopted<sup>85</sup> by the Ninth Circuit in *Cybersell, Inc. v Cybersell, Inc.*,<sup>86</sup> a late 1997 decision which was also the first circuit court opinion to evaluate whether jurisdiction could be obtained over a defendant, consistent with due process, based solely on the defendant’s operation of a passive web site. In *Cybersell, Inc.*, the Ninth Circuit held that jurisdiction could not constitutionally be asserted simply because an out-of-state defendant operated a passive web site accessible to residents of the forum state. The site at issue displayed the name, logo, and local (as opposed to toll-free<sup>87</sup>) telephone number of the defendant and included a link that invited visitors to submit their names to obtain additional information. The court quoted *Zippo Dot Com* for the proposition that “courts that have addressed interactive sites have looked to the ‘level of interactivity and commercial nature of the exchange of information that occurs on the Web site’ to determine if sufficient contacts exist to warrant the exercise of jurisdiction.”<sup>88</sup> In finding that the defendant operated “an essentially passive home page on the

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83 *Inset Systems, Inc v Instruction Set, Inc* 937 F supp.161 (D. Conn. 1996)

84 952 F. Supp. 1119 (W.D. Pa. 1997).

85 The Ninth Circuit did not expressly state that it accepted the *Zippo Dot Com* court’s analysis, but analyzed the facts before it in terms of the three categories outlined there and expressly quoted *Zippo Dot Com*’s analysis of interactive web sites.

86 130 F.3d 414 (9th Cir. 1997).

87 The jurisdictional significance of maintaining a toll free number is questionable. Given the number of different area codes that may exist within a single metropolitan area and the frequency with which people travel on business, it is not unusual for small businesses that operate primarily within a single state (or even county)—such as real estate brokers and mortgage bankers—to maintain toll free numbers for the convenience of existing and potential clients.

88 130 F.3d at p 418.

web,” the Ninth Circuit did not actually focus on the site’s level of interactivity as much as on the more traditional analysis of the contacts between the defendant, the forum state, and the underlying cause of action.<sup>89</sup> The court stated “*while there is no question that anyone, anywhere could access that home page and thereby learn about the services offered, we cannot see how from that fact alone it can be inferred that Cybersell FL deliberately directed its merchandizing efforts toward Arizona residents.*”<sup>90</sup> The Ninth Circuit held that, without “*‘something more’ to indicate that the defendant purposefully (albeit electronically) directed his activity in a substantial way to the forum state*” the court could not find jurisdiction proper based on the operation of a passive web site.<sup>91</sup> “*Otherwise, every complaint arising out of alleged trademark infringement on the Internet would automatically result in personal jurisdiction wherever the plaintiff’s principal place of business is located . . . [which] would not comport with traditional notions of what qualifies as purposeful activity invoking the benefits and protections of the forum state.*”<sup>92</sup> The court also emphasized, however, that in evaluating minimum contacts in Cyberspace, all contacts including those occurring on *terra firma* should be considered.<sup>93</sup>

Under the *Zippo Dot Com/Cybersell, Inc.* guidelines, specific jurisdiction may be found where, in addition to operating a passive web site, a defendant has other contacts with the forum, or where its Internet presence allows for some level of commercial interactivity. Mere advertisement on the web, without more, is insufficient to confer jurisdiction under this analysis. Courts clearly are convinced that the nature of a defendant’s web site is relevant to the jurisdictional issue, but a failure to articulate why it is relevant makes it difficult to determine where the jurisdictional line should be drawn in cases that fall between *Zippo*’s two extremes. A recent opinion by Chief Judge Harry Edwards of the D.C. Circuit Court of Appeals provides a glimmer of guidance. *GTE New Media Services, Inc. v. BellSouth Corp. et al.*<sup>94</sup> involved the application of the District’s long arm statute, which required that, before asserting jurisdiction over a defendant whose activities outside the District had caused harm to a plaintiff there, the defendant either regularly do or solicit business there, engage in another persistent course of conduct there, or derive substantial revenue from goods used or consumed, or services rendered, there. The court was clear that merely because an interactive web site of the defendant was available to District residents, the defendant was not, therefore, automatically subject to the District’s jurisdiction. It is not the nature of the site *per se* that is critical. In certifying its

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89 The court wrote that:

Cybersell FL did nothing to encourage people in Arizona to access its site, and there is no evidence that any part of its business (let alone a continuous part of its business) was sought or achieved in Arizona. To the contrary, it appears to be an operation where business was primarily generated by the personal contacts of one of its founders. While those contacts are not local, they are not in Arizona either. No Arizonan except for Cybersell AZ ‘hit’ Cybersell FL’s web site. There is no evidence that any Arizona resident signed up for Cybersell FL’s web construction services. It entered no contracts in Arizona, made no sales in Arizona, received no telephone calls from Arizona, earned no income from Arizona, and sent no messages over the Internet to Arizona.

Ibid. at p 419.

90 Ibid. at p 414.

91 Ibid. at p 418.

92 Ibid. at p 420.

93 Ibid at p 419.

94 199 F.3d 1343 (D.C. Circ. 2000).

jurisdictional decision for appeal, the district court in *GTE* had noted that other cases basing jurisdiction on an interactive site had involved defendants with other contacts with the forum related to the cause of action.

To date, apparently no other country has focused on the degree of a site's interactivity in assessing jurisdiction. In part, this may reflect the relative lack of case law outside the U.S. dealing with electronic commerce. But in part its irrelevance may be systemic; if the central issue is where acts occurred rather than what choices a defendant has made, interactivity would be relevant only in determining whether, for example, a transfer of digital property was 'performed' at the seller's or buyer's terminal.<sup>95</sup> Although taxation deals with a very different set of relationships than the areas covered by this section. Nevertheless, there are connections that can be usefully made, and the pervasiveness of jurisdiction as a fundamental determinant of the structure of e-commerce makes it imperative that it be included in any comprehensive discussion of taxation issues affecting e-commerce. The difficult jurisdictional issues that arise when the world's principal tax systems begin to collide with the emerging world of global e-commerce essentially concern enterprises, and individual taxpayers. Conceptually, there are two distinct issues. The first is the issue of when it is appropriate for a state to subject persons outside its borders to the economic burden (as opposed to the administrative burden) of a particular tax because of contacts with that state, which are in whole or part electronic in nature. The second significant issue is to determine when a state can legitimately ask that a foreign person be asked to assist in the collection of a tax on others, where those others are within the state's legitimate taxing jurisdiction. The distinction made here, between jurisdiction to impose the burden of a tax and jurisdiction to impose a duty to help collect a tax, is not one that is reflected in the actual law of jurisdiction that has developed, but in a more global and technologically sophisticated economy it may become increasingly important to make this distinction. However, governmental entities should be cautious about imposing jurisdictional oversight and protections that will have extra-jurisdictional implications. The question of jurisdiction ultimately is the question of revenue: if jurisdiction could be established, can taxation be far behind?

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<sup>95</sup> The difficulty in sensibly 'locating' acts in Cyberspace was at the centre of one of the seminal articles on jurisdictional issues in this new era. David R. Johnson and David G. Post, *Law, and Borders—The Rise of Law in Cyberspace*, 48 *Stand. Law Review*. 1367 (1996)

# Chapter – 5

## DIRECT TAXES IN A NETWORK WORLD

### INTRODUCTION

As discussed earlier PE is used to determine a taxable nexus and allocate jurisdiction between the source and residence countries for the taxation of business profits of multinational enterprises. Today however, technology has changed the way companies conduct business. It is no longer necessary to have a physical place of business in a country in order to sell products or services in that country. Hence the question here is where should electronic transactions be taxable—the geographical location of the consumer, the physical site on which the seller's home page is operated, or the location where the seller is resident?

A hypothetical electronic transaction as illustrated by Paris (2001) showed these complexities. Suppose an e-commerce firm has its headquarters in country 'A', and the company accepts customers ordered through a website that is maintained in country 'B'. The website then transmits orders to the company's sales department in country 'C'. A customer residing in country 'D' places an online order. The order would be channelled electronically through a chain of servers in number of locations, ultimately arriving at the company's website in country 'B', which in turn would transmit the order to the sales office in the country 'C'. Let further assume that the company has 'storage facility' in yet another jurisdiction country 'F'. After approving the order, the sales office arranged for shipment of the product from the storage facility in Country 'F' to the customer. If the product was digitised then it might be delivered electronically directly to the customer who could be located anywhere in the world. The company, in other words, has no idea of where in physical world its digitised product would be delivered. Furthermore, if the product was digitised the company's storage facility could amount to nothing more than a computer hard drive or server or an array of 'mirror' servers located in several different jurisdictions. In this case, the storage facility from which the company's product was delivered might be just as mobile as the customer receiving the product might. However, not all the e-commerce transactions today are as complicated as this hypothetical example, but the hypothetical transaction illustrated the difficulties involved in determining the geographical source of income, and the residency status of those engaged in income-producing activities, within world of e-commerce. The question is where is the source of income in the above example? Is it country 'A' where the company has its headquarters, country 'B' where the company has its website, country 'C' where the sales office processed the order, or is it the country from which the product was delivered? Much of this would depend on the definition and application of the concept 'PE'. To the extent that income-generating activities took place in a country where the company had a 'PE' or a 'fixed place of business', that country would be entitled to tax the profits attributable to the establishment. How does a web site fit into the structure of a PE? Is a web site a 'fixed place of business'? If so, where is it located? Is it in the jurisdiction where the retailer is physically present or on the electronic server, that serves the web site? Even if it is a fixed place of business in a taxable jurisdiction, is the web site merely used solely for the display, delivery or advertising of goods or services?

Income tax treaties do not provide easy answers to these questions because they were developed in a non-digital era when transactions and commercial law dealt primarily with tangible property. As noted earlier there are two prevailing approaches to direct taxation: one based on the 'source' principle, and another based on the 'residence' principle. Taxation based on the source principle, however, presupposes that taxing authorities can determine the geographical source of income, while taxation on the residence principle requires information about the identity and residency status of those engaged in income-producing activities. E-Commerce however breaks down the necessary and clear connection between territory and commerce, and makes this type of information more difficult to obtain, thus complicating the task of taxing

income based on source or residence. To complicate matters further, there is a real difference of opinion between the developed and developing countries as to the appropriate approach in allocating taxable jurisdiction. Developed countries generally prefer to allocate taxable jurisdiction based on the enterprise's residence. Hence, if residence is used as the principal criterion to decide taxable nexus for e-commerce, the bulk of the revenues generated from such commerce will accrue to the developed countries. If, however, taxable nexus is based upon the site of the server, it is entirely possible that the developing countries might attach some revenues on the basis that the source of the income is within their jurisdiction. Residence-based taxation creates problems because of the difficulties in placing the central mind and management of an enterprise, particularly with e-commerce, which by its very nature is mobile. The question is what would be the effect of these changes brought by e-commerce would cause to direct taxation. As most commentators have suggested, there is significant concern on the part of the fiscal authorities in various countries that e-commerce has the potential for significantly eroding their income tax base. The potential sources for this erosion could be summarised as follows:

- Out-of-state businesses that in the past needed to have a PE to do business with their customer base within the taxing jurisdiction would no longer need to have one.
- It would be easier for domestic businesses to migrate to tax havens. This could be aggravated by tax competition from less developed nations seeking to attract capital by offering lower tax rates to businesses that migrate there.
- The general increase in cross-border trade would create increased opportunities for business to exploit the discontinuities between various national tax systems.
- The ability of financial institutions to create derivatives that can arbitrage tax discontinuities has been facilitated by the speed and flexibility supplied by the new technologies.
- The geographic flexibility of e-business may make it difficult to identify the residence of a particular business, particularly in those jurisdictions that base the residency of a business entity not on where it was formally organized, but where its 'seat of management' or 'principal place of business' located. The cliché is that the global business may be resident everywhere and nowhere.
- To the extent the Internet permits business transactions to go forward without the intermediation of significant financial and commercial institutions, a major source of compliance and enforcement related information reporting might be lost.
- The unprecedented nature of some forms of e-commerce and e-products creates definitional ambiguity. By blurring the distinctions between categories - tangible versus intangible, goods versus services, license versus sale - that have different tax rules, tax authorities feel compelled to draw finer and finer bright-line distinctions separating those categories. The result of this process is the creation of discontinuities in the system

whereby transactions that differ in only minor details of form and not at all in substance have dramatically different tax consequences. Such discontinuities lead to uneconomic tax-motivated behaviour on the part of some taxpayers and a strong perception of general unfairness and arbitrariness in the system among the rest.

Although tax avoidance and tax evasion have always been problems, with which tax authorities have had to contend. There had always been certain businesses that choose to locate their corporate headquarters or to conduct their business activities from states that offer low or no tax regulation. The cost of conducting offshore activities, however, can often outweigh the benefits of tax relief. For this reason, tax avoidance and evasion opportunities of this nature had been generally exploited by only a small number of businesses, as the majority were unable to support such schemes. Traditionally businesses had been deterred from locating in tax haven countries by other problems inherent to these countries. Although they could offer appealing tax rates, but businesses also had to consider other characteristics that might not be conducive to maintaining a globally competitive business. Such characteristics include climate or geography that is not suitable to the particular business, high labour costs, low education levels, poor infrastructure, political instability, or a small consumer base. However, a business operating through a commercial website, would be not subject to the same physical constraints as a 'bricks and mortar' business. For example, a small or medium sized business in UK could easily post its Web site with a host who operates from a tax haven country. In such a case, it would still be able to access profitable consumer bases while having its financial information hidden by the privacy protection that tax haven countries often provide. The fact that an e-commerce business would not require any physical presence other than a server also would make the problems identified above irrelevant. It would not only be affordable for virtually any e-commerce business to locate in a tax haven, but all of the incentives for doing so would remain while the disincentives would gradually disappear. Therefore, when business is conducted on the Internet the problem of tax competition reaches a new level of complexity. For some business, many of the physical constraints on tax evasion or avoidance remain. However, with digital goods and services that can be transacted entirely over the Internet, states cannot rely on physical controls to prevent or deter tax avoidance and evasion. These and other tax issues has been the subject of discussion in a number of reports for past two years. Of particular importance in this respect are the reports produced by the US Treasury Department and by OECD, not only because of the positions advocated in these reports, but also because of the significance of the institutions behind them.

### 5.1 PERMANENT ESTABLISHMENT IN E-COMMERCE

Article 5 (1) the OECD Model Tax Convention defined PE as: '*a fixed place of business through which the business of the enterprise is wholly or partly carried out*'. PE involves three requirements:

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<sup>1</sup> OECD (1998) Model Tax Convention on Income and Capital, June 1998. Art 5 (1) OECD Model Tax Convention.

- the existence of a place of business;
- the fixed nature of this place of business; and,
- conducting the business of the enterprise through this fixed place (i.e.: agents who are dependent on the enterprise conduct its business through this fixed place). Economic allegiance must involve having people working for the enterprise in another country through a fixed place of business.

There is a clear attempt to distinguish substantive economic activity, which creates a taxable presence, from mere 'preparatory or ancillary' activity; the latter, although conducted through a 'fixed place of business,' does not create a taxable PE. Although not free from doubt, the PE concept, with its requirement of a 'fixed place of business', tends to lend some certainty to the circumstances in which a non-resident person would be subject to tax in a host country. However, the OECD has been struggling with the application of the PE definition in the context of e-commerce. In late 1999, the OECD's Working Party No. 1 on Tax Conventions and Related Questions released a discussion draft of commentary ('OECD Draft') that would clarify the definition of PE in Article 5 of the OECD Model Treaty<sup>2</sup>. The 'OECD Draft' concluded that while fixed automated equipment operated by an enterprise and located in a country may constitute a PE, a distinction needed to be drawn between computer equipment and the software used by such equipment. Thus a website which is a combination of software and electronic data, does not have a location that can constitute a 'place of business' as there is no '*facility such as premises or, in certain instances, machinery or equipment*'<sup>3</sup> as far as the software and data constituting that website is concerned hence it does not have any tangible property. Its exact location is also unknown. Accordingly, the website by itself cannot be treated as PE (OECD, 2001).

Article 5 of the OECD Model Tax Convention also distinguishes when, and under what circumstances, the activity within the host country of an agent of the non-resident principal would establish the requisite nexus to permit direct taxation of the principal's business activities by the host country where there is no 'fixed place of business'. A non-resident person would not have a taxable presence solely because of using an agent, regardless of the type of activity carried out on behalf of the principal. Rather, the agent must be 'dependent,' that is, dependent both legally and economically, on the principal. Beyond that, the agent must be able to enter into contracts in the name of the principal, which, at least, means that the agent must be able to bind the principal to a contract as a matter of local law. If, however, the agent is independent, a PE does not exist because of the agency.<sup>4</sup> Regarding this, the 'OECD Draft'<sup>5</sup> concluded that since a web site is

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<sup>2</sup> OECD, The Application of the PE. Definition in the Context of Electronic Commerce: Proposed Clarification of the Commentary on Article 5 of the OECD Model Tax Convention, Revised Draft for Comments, March 3, 2000.

<sup>3</sup> Para 2 Commentary on Article 5 OECD Model Tax Convention

<sup>4</sup> OECD Model Convention, Articles 5(5) and 5(6)

<sup>5</sup> OECD, 'The Application of the Permanent Establishment Definition in the Context of Electronic Commerce: Revised Draft', 20 Tax Notes International 1199, March 13, 2000.

not a person, as defined in article 3<sup>6</sup>, a web site could never be the dependent agent of an enterprise. Even if 'artificial intelligence' software is loaded on a server, it will not create a PE for an enterprise under paragraph 5 of the Model Tax Convention. An Internet service provider does not constitute an agent of the enterprise for the purposes of PE because it does not have the authority to conclude contracts<sup>7</sup> (OECD, 2001).

Although the OECD Model Tax convention specifically referred to a dependent agent as a 'person', that term was not exhaustively defined (Article 3) and was intended to be interpreted widely. The web site performs the tasks that the enterprise programmed it to do, similar to the tasks that an agent performs based on instructions from his principal. Sophisticated web sites can actually solicit customers by sending e-mail to potential customers and are capable of carrying on the business of the company per its instructions. Using 'artificial intelligence', it can refine the list of customers and actually target likely customers based on past responses. This means that web site has the capability to provide instantaneous information concerning products and services. Further, by means of intelligent software a website acting on behalf of an enterprise may have the authority to conclude contracts in the name of the enterprise. It can also be programmed with all the required instructions *from the enterprise to the power to accept sales and allow the conclusion of a sale*. This activity is similar to a person having the authority to conclude having the authority to conclude contracts in the name of the enterprise. The same thing is happening when a purchase is made on-line. The user inputs the information required by the web site and being in accordance with the instructions and requirements programmed; the purchase is authorised automatically without the need of a human approval. It is important to note that the web site alone cannot perform these functions. It must work with the server to accomplish these tasks. Thus, the web site itself does not constitute a dependent agent for the enterprise, but working along with a server it satisfies the conditions of article 5(5) and thus may constitute a PE in the state where the server and the web site are located.

A server is a special type of computer, which works as the hub of a computer network. The server can function as the primary site where information is stored, if part of a network, or as a gateway for incoming and outgoing information. A server may perform as stand-alone equipment and not as part of a network. In this case, the server earns its name because it is 'serving' web pages to users over the Internet. When a server is part of a network of computers, it acts as the brain of the network allowing other computers to send and receive information as a network.<sup>8</sup>

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<sup>6</sup> Article 3 of the OECD Model defines the term 'person' including an individual, a company, and any other body of persons.

<sup>7</sup> OECD (2001) at pp 80, 84-85

<sup>8</sup> Judd A. Sher, (1999) at p 424.

As discussed earlier server on which the website is hosted would be a PE provided it constitutes a *'fixed place'*. Therefore, to constitute a 'fixed place of business' a server needs to be located at a certain place for a sufficient period to become fixed within the meaning of paragraph 1 of article 5. In addition, the activities carried on through the web site hosted on it relate to the *'core functions'* of the business of the enterprise and are not merely preparatory or auxiliary in nature. Hence according to the position of 'OECD Draft', a server in which a web site is stored and used is a piece of equipment having a physical location and may thus be a 'fixed place of business' of the enterprise that operates it.<sup>9</sup> The 'OECD draft' further emphasizes that the distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, it is common for the web site through which an enterprise carries on its business to be hosted on the server of an ISP. Although fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not give to the enterprise to which the web site belongs any right to a particular space or control over the operation of the server (as opposed to the operation of the web site software itself). In such case, the server and its location are not at the disposal of the enterprise, even if the enterprise has determined that its web site should be hosted on a particular server at a particular location; but the enterprise does not even have a physical presence at that location since the web site does not involve tangible assets. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site also owns (or leases) and operates the server on which the web site is stored and used, the server could constitute a PE of the enterprise if the other requirements of the article 5 of OECD Model Tax Convention are met.<sup>10</sup>

It can be argued that the situation of renting space on the server of an Internet provider is similar to renting an office or a building through which the enterprise carries on its business. In both cases, the enterprise is renting a physical location. The only difference is that in the case of the building or office rental, the enterprise has the option to choose the State in which it will operate while under the server arrangement the enterprise may not have this option. It is the ISP, which controls and operates the server. If, however, the server is owned or leased by the enterprise owning the website then it is *'at the disposal'* of the enterprise and would constitute a PE. Hence, some argue that the mere maintenance of a web site on a server located in a taxing jurisdiction satisfies the requirements for a PE<sup>11</sup>.

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<sup>9</sup> OECD, The Application of the Permanent Establishment Definition in the Context of Electronic Commerce: Revised Draft, *20 Tax Notes International* 1199, and March 13, 2000.

<sup>10</sup> Ibid

<sup>11</sup> For example, the Income Tax Department of India working group to examine the tax implications of e-commerce transactions recommended that a computer terminal which is used to receive and send information across national boundaries and a website used in e-commerce should be regarded as a PE. In addition, the Australian Tax Office in its discussion paper stated that even a web site located on a

However, e-commerce is largely indifferent to the location of hardware thus, the fact that, for instance, a clothing retailer's electronic catalogue resides on a server in a given country does not give the clothing retailer a fixed, vested, economic interest in that country in the same manner that a factory or office would. For example, if the clothing retailer's only physical presence in a country was through a server, the clothing company would not particularly care about the composition of the country's workforce, whether the country's transportation system was functional, or whether the country was politically stable. All of these considerations would be more important if the clothing retailer had a factory or office in that country. All these aspects are taken into consideration only when an enterprise intends to carry on business in a certain State. Those facts and circumstances are a part of a business decision as to where an enterprise would open an office or build a factory and demonstrate the character of permanence intrinsic to the concept of PE (Forst, 1997).

However, what happens when the business may be said to be wholly or partly carried on through equipment such as a server that it controls and operates. Some countries believe that the issue is already dealt with in paragraph 10 of the OECD commentary, which expressly recognises that the business of an enterprise may be carried on through automatic equipment. Other countries, however, draw a distinction between the example, given in that paragraph, of a gaming or vending machine and servers used in e-commerce operations. These countries consider that in the case of a gaming or vending machine, the machines are in a fixed place of business and enter into completed transactions with customers to provide goods or services. They note that a vendor who changes locations each week would quickly lose its customers. The location of a server is, however, irrelevant to the customer of an e-commerce operation, since the customer has access to the business goods or services wherever the customer has an Internet connection. Thus, an *e-tailers* business is carried on, not through the server, but through the enterprise's offices, warehouses, research facilities, and other locations in which its income-generating activities take place. According to these countries, the server in these circumstances does therefore not meet the requirement that e-tailers have 'fixed place of business'.<sup>12</sup>

The commentary also provides that a PE can exist where the business of the enterprise is carried on mainly through automated equipment with the activities of the enterprise's personnel being restricted to setting up, operating, controlling, and maintaining such equipment. As an example, the Commentary addresses gaming and vending equipment and provides that whether such machines constitute a PE depends on whether the

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server that is fixed in time and location, and through which business is carried on might constitute a PE.

<sup>12</sup> OECD, 'The Application of the Permanent Establishment Definition in the Context of Electronic Commerce: Revised Draft', (March, 2000).

enterprise carries on business activity besides the initial setting up of the machines.<sup>13</sup> If the enterprise merely sets the machines up and then leases them to operators in the other State, then no PE results. However, if the enterprise also operates and maintains them for its own account, then a PE will occur, and this result follows if the machines are operated and maintained by the enterprise's dependent agent.

A further issue is to what extent human intervention is necessary for automatic equipment to be considered to constitute a PE of an enterprise. Under one view, automated equipment that does not require human intervention for its operation may constitute a PE. The relevant question, in such case, would be the nature of the business and whether the activities performed through the equipment are the core income-generating activities of the business. This view is taken because it would be illogical to conclude that personnel are necessary to have a PE when no personnel are in fact necessary to generate income.<sup>14</sup> There is also another view that some human intervention would be necessary for a PE to exist. However there are different views, as to the exact parameters of that requirement. Those differences relate to the following questions:

- whether the intervention must necessarily take place in the country or can be done from abroad;
- whether the intervention needs to be that of employees of the enterprise or of any person, whether or not employed by the enterprise;
- what level of human intervention is required?

On the first question, some consider that the intervention must be that of persons who are present for that purpose in the country where the equipment is located. According to this view, it is only under these circumstances that an enterprise could be regarded as participating in the economic life of that country like domestic enterprises.<sup>15</sup>

On the other hand, in the 'pipeline' case, The Second Chamber of the German Supreme Court held that an underground oil pipeline, located in Germany, but regulated by computer from the Netherlands constituted a PE in Germany for purposes of German business property tax. German law defines PE in the same manner for both its income tax and net worth tax. Clearly, the pipeline was integral to the taxpayer's business and there was a significant degree of permanence to the pipeline. The court held that the pipeline constituted a fixed place of business in Germany. With respect to the requirement that the pipeline must serve the taxpayer's business, the court stated that a fixed place of business serves a business activity when a taxable person exploits it for a certain period for business purposes. Did the Dutch company exploit the

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<sup>13</sup> Contrast gaming and vending machines, ATMs, and juke boxes, where a user's entire transaction is conducted by interaction with the machine, with the activities conducted or functions performed at the site of a computer server on the Internet, which are normally more limited.

<sup>14</sup> An example of equipment that operates automatically is the automatic pumping equipment used in the exploitation of natural resources.

<sup>15</sup> OECD, 'The Application of the Permanent Establishment Definition in the Context of Electronic Commerce: Revised Draft' (March 2000).

German stretch of the pipeline by operating it by remote control from the Netherlands? According to the court, a taxpayer need not be physically present at the fixed place of business to exploit it. The deployment of persons (an entrepreneur, an employee, independent contractors, or other) to the fixed place of business is not always required, rather in the case of fully automated equipment the exploitation of the fixed place of business for the purpose of the taxpayer's business is sufficient. The court did not elaborate on this statement, but its ramifications for e-commerce are obvious. The statement could be interpreted to mean that even though a taxpayer not physically present in a particular country could have a PE in that country through its virtual presence.<sup>16</sup> The German tax authorities recently issued a pronouncement which provides that 'for the time being' (i.e., pending the discussions at the OECD level), German authorities would take the position that a server does not create a PE pursuant to Article 5, paragraph 4 OECD Model Tax Convention because the activities have to be classified as being of a preparatory nature, despite the view taken by the German Supreme Court in its so-called '*Pipeline Decision*' (Hey, 1999).

A related question could be about the passive use of an asset for operational reasons. The European Court of Justice had the occasion to consider whether such use would amount to a PE in a judgement of July 4, 1985<sup>17</sup>. The European Court held that the definition of a fixed place of business presupposes both physical resources as well as personnel who assist the entrepreneur in the use and implementation of the physical resources. The court stated that a fixed place of business could be a piece of equipment (such as a vending machine), but subject to the proviso that it is permanently installed at a specific location and that it requires the employment of human energy for its operation. There are different views regarding the level of human intervention would required A PE to exist. Some commentators argued that what matters is whether or not the equipment is operated, and not merely set up and maintained, by persons, while others think that it may be difficult to distinguish the operation from the maintenance of computer equipment, especially when databases are updated or software upgraded.

As seen above, it is possible that a server would satisfy the general rule of article 5(1) of the OECD Model Convention and thus constitute a PE. However, paragraph 4 contains an exception to the rule of paragraph 1, listing a number of activities that might be carried on through a fixed place of business, without creating a PE. A facility is not a PE if it is used solely for purchasing, storing, displaying, or delivering goods, collecting information, or carrying on any other type of activity of a 'preparatory or auxiliary character'<sup>18</sup>. Is it possible to think of a server as a storage facility, as falling within one of the exceptions of paragraph 4? The U.S. Treasury, in its White Paper, took the position that the use or lease of a computer server generally does not create a PE, because of paragraph 4, analogising the server as to facilities used for storage and

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<sup>16</sup> David L. Forst, at p 1459.

<sup>17</sup> Judgments of the European Tax Court

<sup>18</sup> Boris I Bittker and Lawrence Lokken, at pp 66-97

display.<sup>19</sup> Where a business sells information instead of goods, the White Paper provides that 'a computer server might be considered the equivalent of a warehouse, which is excepted from the definition of PE'.<sup>20</sup> Nevertheless, where the server is integral to the business (e.g. an ISP), the White Paper recognizes that the exception may no longer apply.<sup>21</sup> However, even though a server hosts a web site, what could be seen as storing or displaying data and software, a server does more than that. In fact, it also operates the web site and allows the connection between the web site and its user. As a result, the exception provided in paragraph 4 (a) of article 5 is not applicable to a server, and thus a fully automated server may give rise to a PE. As in the case of a web site, the server could possibly be treated as a dependent agent under paragraph 5 of article 5 of the OECD Model Tax Convention to constitute a PE<sup>22</sup>. As I have discussed previously in this section that the OECD Model Convention reference to a dependent agent as being a 'person' must be examined taking into consideration the that the Model was drafted at that time when existence and the development of the Internet and e-commerce was unforeseeable and hence dependent agents were expected to always be persons. Although, the Treasury White Paper rejects this view because the activities or services performed by the server do not include contractual authority that is normally associated with a dependent agent. As seen above, by means of intelligent software, the web site is able to conclude contracts for the enterprise hence Italy, has taken the position that where the server is loaded with 'intelligent software' that can conclude simple contracts, the server's actions become similar to that of an agent, and thus may sufficient to give a business a PE.<sup>23</sup> It seems, however, that the server needs to host a web site in order to perform such tasks for an enterprise. The server by itself will not act on behalf of the enterprise. A server is more likely to constitute an independent agent for the enterprise acting in the ordinary course of their business, as evidenced by the fact that they host the web sites of many different enterprises.

In the end, an expansive view of PE may have theoretical appeal, especially where, for example, the human presence has been replaced by a form of 'virtual' presence, such as the remote control of equipment from a foreign country. In such a case, neutrality would require that the enterprise conducting the activities from a remote location receive the same treatment as the enterprise that physically sends its employees to the site of the equipment for its operation and maintenance. According to the neutrality principle, if the latter activity gives rise to a PE, so should the former. Further more, a broad interpretation would apparently ensure the vitality of the PE concept in the age of e-commerce. However, at least in the case of computer

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<sup>19</sup> *Selected Tax Policy Implications of Global Electronic Commerce*, Department of the Treasury, Office of Tax Policy), (Treasury White Paper)

<sup>20</sup> Id. Art. 5, paragraph 4(a) excludes from the definition of permanent establishment the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise.

<sup>21</sup> Levine, Howard J. at p 229.

<sup>22</sup> The server performs the tasks of the corporation that programmed it. As with a web site, the server acting as the brain of the agent performs its functions in furtherance of its master (the responsible party for programming it). Thus, in this manner a server may be seen either as a dependent agent itself or as extending the foreign enterprise in such a way as to establish its business presence within the other country Judd A. Sher, at p 425

servers, such an interpretation is problematic. The views of the OECD are consistent with the existing rules and principles. However, it is important to point out that treating the server which hosts the website, is at the disposal of the enterprise and performs 'core business functions' of the enterprise as PE will not address the crucial issues arising from growth of e-commerce. Nevertheless, one may question whether that premise makes sense in the context of e-commerce. At a fundamental level, one can argue that it makes little sense to attempt to fine-tune a definition of PE, rooted in concepts of physical presence, for a universe of transactions in which physical presence is often irrelevant<sup>24</sup>. Treating the server as PE will not create certainty of tax burden or ensure maintenance of the existing equilibrium in revenue sharing between countries of residence and source. More than one server may be used by the enterprise making the location of the server actually performing specific functions in the source country difficult to determine. The location of the server is easy to manipulate. There is nothing to prevent it being located in a low tax jurisdiction or a tax haven and not in the source country. Even if the server is located in the source country, in e-commerce huge volume of transactions can be conducted without any requirement of office and staff in the source country. The attribution of income to the PE and taxation in the source country, in terms of Article 7 of the Convention, would be negligible.

At a fundamental level, one can always argue that it makes little sense to attempt to fine-tune a definition of PE, rooted in concepts of *physical presence, for a universe of transactions in which physical presence is often irrelevant*. In fact, the OECD itself has recognized these concerns by mandating its Technical Assistance Group on Monitoring the Application of Existing Norms for Taxation of Business to consider and comment on the following questions:

- whether the concept of PE provides an appropriate threshold for allocating tax revenues between source and residence countries with respect to the use of tax havens in the context of electronic commerce;
- whether there is a need for special rules relating to electronic commerce and whether such rules would be a viable alternative to existing international norms<sup>25</sup>.

Having examined the e-commerce under the existing rules of PE, the following conclusions could be reached. *First*, websites, web hosting arrangements, and ISP should generally not be treated as PE. *Second*,

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23 Fairpo, Anne *Electronic Commerce-U.K. Policy Document*, at p 4.

24 In fact, the OECD itself has recognized these concerns by mandating its Technical Assistance Group on Monitoring the Application of Existing Norms for Taxation of Business to consider and comment on the following questions:

(i) whether the concept of permanent establishment provides an appropriate threshold for allocating tax revenues between source and residence countries with respect to the use of tax havens in the context of electronic commerce;

(ii) whether there is a need for special rules relating to electronic commerce and whether such rules would be a viable alternative to existing international norms.

25 OECD, *The Application of the Permanent Establishment Definition in the Context of Electronic Commerce: Proposed Clarification of the Commentary on Article 5 of the OECD Model Tax Convention*, Revised Draft for Comments, March 3, 2000.

since the server is a piece of equipment having a physical location, it may constitute a PE. Nevertheless, the server itself does not conduct business for the enterprise without the web site. Thus, if an enterprise carrying on business through a web site also operates (by owning or leasing) a server on which the web site is stored and used, the server, along with the web site, may constitute a PE (Lodin, 2001, Kobrin, 2001)<sup>26</sup>. The UK has opposed the possibility that servers may constitute PE<sup>27</sup>. The Indian Finance Ministry's Report criticized the definition of servers as PE for the following reasons. It noted the problem of enriching tax havens and consequent uncertainty with regard to the collection of tax revenues. It suggested the search for an alternative to the concept of PE within the OECD or the UN. It was concerned that the server as PE could threaten the existing revenue distribution equilibrium between countries of residence and countries of source. To avoid this problem, the Finance Ministry proposed that when the 'place of effective management' is tough to establish, source-based rules should apply (Central Board of Direct Taxes, 2001)<sup>28</sup>.

The views of the most of the developing countries are clearly in favour of a change; while most developed countries are in believe of adopting the exiting views. According to Professor Chang Hee Lee (1999) '*maintaining existing rules and concepts benefits the countries that export goods, services and capital*'. In addition, the rule that business profits are not taxable without PE in the source country presupposes that any massive sales are not possible without a PE. It is also implicitly presumed that without sales activity in a country no sales are possible, which is no longer the case with the advance in technology.

## **5.2 E-COMMERCE AND CONCEPT OF RESIDENCE AND SOURCE**

Countries generally exercise jurisdiction to tax income based on residence or source. Both of these concepts are likely to become more elusive in the context of e-commerce.

### **5.2.1 RESIDENCE BASED TAXATION**

Determining the residence of a taxpayer is generally uncomplicated because a country of residence essentially is the geographic location where a taxpayer has the closest personal links.<sup>29</sup> According to the OECD Model Tax Convention, a resident country is where one has:

*"Domicile, residence, place of management or any other criterion of a similar nature,' and if 'he has a permanent home . . . in [two or more] States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests)"*<sup>30</sup>

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26 Lodin (2001) at p 5; Kobrin (2001) at p 694

27 OECD (2001) Taxation and Electronic Commerce (Paris: OECD) at p 82

28 Central Board of Direct Taxes (2001) at pp 64-75

29 Treasury White Paper paragraph 7.1.5.

Most of the countries determine residence of a person based on the period of stay in the country. Paragraph 3 of Article 4 of the Convention provides that in case there is a tie in determining the residence of a non-individual assessee, the non-individual shall be deemed to be a resident only of the state in which its '*place of effective management*' is situated. '*Place of effective management*' was not defined in the Convention. Paragraph 24 in the Commentary on Article 4 of the Convention, which was included in the year 2000 update to the Commentary, indicates that for determination of the effective place of management, no definite rule can be given and that all relevant facts and circumstances would need to be examined. It, however, clarifies that '*the effective place of management*' would be where key management and commercial decisions necessary for conduct of the business of the enterprise are taken. The commentary rejects purely formal criteria like registration in deciding the conflict of residence between two nations. With the growth of e-commerce, place of registration of a company has become even more irrelevant than before. The advances in communication technology make it possible for directors sitting in different countries to easily, and simultaneously, communicate with each other through video-conferencing. It is no longer necessary for the Boards to meet at a fixed place, as was the practice in the past. This makes the determination of the '*place of effective management*' extremely complicated.

A draft paper circulated by OECD in February, 2001 titled '*The Impact of the Communications revolution on the application of Place of Effective Management as a Tie-breaker rule*' points out that many commentators are influenced by the concepts used in domestic laws such as '*central management and control*' used in the Australian Income Tax Act, 1936 and '*place of management*' adopted by a number of treaty countries. Some countries like Switzerland use the concept of '*place of effective management*' in their domestic laws. According to the draft paper, court decisions in Australia define the '*place of central management and control*' as one where directors of the company exercise their power and authority. The factors taken into account include the place of incorporation, place of residence of shareholders and directors, place where business operations take place, place where financial dealings of the company occur and the place where the seal and the minute book of the company are kept. In Switzerland, '*place of effective management*' is distinguished from the place where merely administrative decisions are taken. Under the German laws, the '*place of management*' is not where the management directives take effect but the place where these are given. Where this cannot be determined, the place of residence of top manager may determine the residence of the company. What is relevant is the place where high-level decisions are taken. If persons other than the directors on the board of a company perform this function, the relevant place is where those other persons take their decisions. However, with the advance in technology and use of video-conferencing or the electronic discussion group applications available via the Internet, it is no longer necessary for directors or other top managers to be located or meet at one place to take decisions. The

decision-makers could be, therefore, located all over the world. Similarly, the top manager of the company may be taking the decisions while on move. Another possibility could be where the company is treated as resident in two countries and the place of effective management lies in a third country. The draft paper suggests four alternatives to resolve the issue of a satisfactory tie- breaker rule, which gives unique solution in all the cases and not just for most of the cases. These are:

- Replace the 'place of effective management' concept;
- refine the 'place of effective management' test;
- establish a hierarchy of tests so that if one test does not provide a solution the next applies; or
- a combination of the second and third alternatives.

There is no real alternative to the concept of '*place of effective management*'. It is not possible to set down a single rule. The 'place of effective management' has to be determined based on facts and circumstance of each case. The existing concept gives a unique solution in most cases. Where in the case of a globally integrated enterprise, no unique solution is available through the concept of 'place of effective management'; the solution could be 'source based' taxation only. However, in contrast to the relative simplicity in finding a country of residence, many uncertainties, and difficulties arise when determining whether a source country may impose tax upon the company for a cyberspace transaction.

### 5.2.2 SOURCE-BASED TAXATION

Origin (source) is the specific place where income is produced. The economists define it as the place where wealth is produced, that is, the community of economic life, which makes possible the yield of the acquisition of the wealth. This yield or acquisition is due, however, not only to a particular thing but also to the human relations, which may help in creating them (Forst, 1997)<sup>31</sup>. Thus, a business may be carried on in the country or income may be accruing from investments located in that country. Business income is taxable only if an enterprise maintains a PE in the country. Income from 'services' is taxed in the country where the service is provided and not where it is delivered or utilised. Taxation of income in the source country, therefore, depends on the existence of PE and characterisation of income. As the cross-border e-commerce expands, it may turn out that source of income becomes more difficult to reasonably determine. The most obvious benefit of residence taxation is ease of administration. It is not necessary to identify the source of economic activity when income is subject to taxation only in the country of residence. This in turn helps those companies engaged in e-commerce in calculation of tax liabilities whose income may not be attributable to any specific geographic location.

The US Treasury paper suggested that '*source based commerce could lose its rationale and be rendered*

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<sup>31</sup> Forst (1997) at p 1460

obsolete by electronic commerce'.<sup>32</sup> It also suggested that e-commerce will 'accelerate' a trend towards preferring residence-based taxation to source-based taxation due to the difficulty of implementing a source-based regime in the world of cyberspace:

*'The growth of new communications technologies and electronic commerce will likely require that principles of residence-based taxation assume even greater importance. In the world of cyberspace, it is often difficult, if not impossible, to apply traditional source concepts to link an item of income with a specific geographical location. Therefore, source based taxation could lose its rational and be rendered obsolete by electronic commerce. By contrast, almost all taxpayers are resident somewhere . . . United States tax policy has already recognized that as traditional principles lose their significance, residence-based taxation can step in and take their place. This trend will be accelerated by developments in electronic commerce where principles of residence-based taxation will also play a major role'.<sup>33</sup>*

Hellerstein (2001) argued that this view of US Treasury is hardly uncontroversial for a variety of reasons. Firstly, as Professor Reuven Avi-Yonah (1997) has observed, 'the recommendation to tax income from electronic commerce primarily or exclusively on a residence basis is inconsistent with generally accepted international consensus, as embodied in tax treaties and in the U.S. international tax regime.' That consensus is based on the principle that the residence jurisdiction has the primary right to tax passive (investment) income while the source jurisdiction has the primary right to tax active (business) income. Abandoning the source-based principle in favour the residence-based principle in the context of e-commerce would therefore violate accepted international norms of tax policy. Secondly, it is by no means clear that residence-based taxation provides a panacea for the difficulties of assigning income from electronic commerce on a source basis. While the task of administering a residence-based regime may be somewhat less daunting than the task of administering a source-based regime with respect to income from e-commerce but Cigler (1997) was of the opinion that 'many international tax professionals have experienced cases which are much more complex leading to the conclusion that the ultimate solution for electronic commerce will not rely on the 'resident somewhere' principle.' Moreover, the 'relative meaningless of corporate residency,'<sup>34</sup> and the ease with which an Internet-based enterprise may establish a corporate residence divorced from any of its 'tangible' activities, suggest that the general adoption of a residence-based regime for electronic commerce could raise as many problems as it resolves. Thirdly, and have particular importance to developing countries and countries with economies in transition, a residence-based rule raises troublesome questions of international tax equity. As Charles McLure (1997) has observed, 'a shift to residence-based taxation would be a boon to the United States, the world's leader in the production of electronic content.' "But," he continues, 'it is troubling to those worry about the ability of

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32 Treasury White Paper paragraph 7.1.5

33 Treasury White Paper at p 20.

34 Reuven S. Avi-Yonah at p 527.

source countries and countries where consumption occurs---especially developing countries---to tax income and consumption.’ David Tillinghast (1996) has expressed similar concerns:

*‘The changes wrought by the Internet . . . , which drastically reduce the need for a seller or a service provider to have a physical presence in the country where its customer is located, threaten fundamentally to alter this division of revenue by shifting the balance of taxing jurisdiction, and revenue, decisively in favour of the country of residence. Since income flows between countries are not necessarily balanced and in the case of flows between developed and developing countries are often severely imbalanced, such a shift could have profound revenue consequences’.*

In short, according to Hellerstein (2001) ‘*wholly apart from the dictates of sound tax policy or practical considerations about enforcement, we cannot lose sight of the fact that the choice of tax principles may well create winners and losers*’. Accordingly, when distributional implications are added to the calculus, a residence-based approach to taxing income from e-commerce may not be particularly attractive. It favours developed countries at the expense of developing countries. Tax havens may undermine fiscal sovereignty, if taxation is based on residence. Tax havens have benefited due to sovereign control over fiscal policy in an age of interdependence. Corporations and individuals can easily shift resources to realize gains from low tax locations, aided by information and communications technology (ICT). According to one estimate, 20% of total private wealth and 22% of bank’s external assets are invested offshore. According to another estimate, a quarter of the US investment went to tax havens in 1994 (Palan, 2002)<sup>35</sup>.

Residence-based taxation with digitised empowers corporate entities to incorporate themselves in tax havens, and, outsource work anytime anywhere (McLure, 2001)<sup>36</sup>. Revenue collection will shift to low tax locations. This would lead to revenue losses for public authorities whose utilities were used for the human endeavour that generated profit, and will contradict the benefit principle (McLure 2000; Li, 1999)<sup>37</sup>. If residence based taxation leads to the empowerment of tax havens in an era of digitisation, this will affect revenue collection in the US. Residence-based taxation will erode the tax base of countries like India, Australia, Ireland, China, Philippines, Russia, Ukraine and Canada, which are involved with value creation, when the major firms doing business along the digitised route and markets reside in the US. As discussed before chapter 2, about the dominance of US firms as consumers of ICT services. Off the total worldwide software sales in 2000/01 of \$ 440 billion, \$ 219 billion occurred in the US. The US consumed 61.1% of India’s exports and 39.2% of Australia’s ICT related exports in 2000/01 (Desai, 2002).

The US as the dominant country of source will gain from source-based taxation. According to one estimate, US e-tailers served 20% of the West European market and 14% of the Asian market (Cairncross, 2001, at 123). Given the US dominance in financial, software, publishing, and entertainment services, sourced-

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35 Palan (2002) at p 156

36 McLure (2001) at p 336

37 Li (1999) at p 1456

based taxation has the potential of substantial revenue potential for the US. Australia has argued for the continuing vitality of source-based taxation. To quote from the Australian White Paper:

*'Unless income is derived from property used in Australia or from acts done in Australia there would seem little likelihood that an Australian court would find that the source of the income was in Australia' (Australian Taxation Office, 1999)<sup>38</sup>.*

The Australian White Paper noted, if the result of the performance of a service becomes more important than the location where the service was really performed, by giving undue emphasis to the place of contract, the place of payment, or even where the services were utilized, this could encourage tax planning. The suggestion is that residence can be more easily relocated to tax havens than the relocation of the actual performance of a highly skilled service (source) (Australian Taxation Office, 1999)<sup>39</sup>. One may conduct deals related to supply of high end embedded software in tax havens, but such software may actually only be produced in Silicon valley. The Indian Finance Ministry's Report (July 2001) expressed concern about the distributional consequences involved with the shift from source to residence-based taxation. Especially worrying for India's tax authority was the fact that equilibrium in revenue sharing between countries of source and countries of residence was not one of the stated objectives of the OECD or the US. It stated the problems of determining residence. It opined that there was no substitute to the 'place of effective management test'. When the 'place of effective management' was tough to determine after giving due consideration to a variety of factors, source-based taxation should prevail (Central Board of Direct Taxes, 2001)<sup>40</sup>.

### 5.3 CHARACTERIZATION OF INCOME

The next substantive issue in deciding who is entitled to tax revenues generated by electronic transactions is the characterisation of income. Under existing international tax treaty rules, each category of income has its own source. It is, therefore, crucial to define the character of income from electronic transactions. Should we treat it as business profits from sales, services income, or royalties' income (which falls under the category of investment income) from the use of intellectual property? Let me consider an example here: I access 'Software Unlimited' a web site, which provides software in order to download 'Interactive tax guide'. They offer me two options. Either I obtain a CD ROM version or I download the program directly from Software's web site. The question is if I choose the first option and the company ships me a CD, what kind of income is this, if on the other hand I choose to download the software would this then change the nature of the income. A gain, while there are rules to determine source of income which works well in conventional commerce, the sourcing of income in e-commerce is much more difficult. Characterisation of income is important because both national and international income tax rules assign different categories of

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38 Australian Taxation Office (1999) at p 79

39 Australian Taxation Office (1999) at p 91

40 Central Board of Direct Taxes (2001) at pp 60-65

income to different jurisdictions. For example, under the OECD Model Tax Convention,<sup>41</sup> and many bilateral conventions, income from personal services is generally sourced in the country where the services are performed, income from rentals and royalties is sourced according to the location of the property or, in the case of certain types of intangible property, where the intangible property is used; and income from the sale of purchased inventory is generally sourced in the country where title passes.

The principle of tax neutrality requires consistent tax treatment for electronic and conventional modes of business. However, the critical question for e-commerce would be how to analogise digital transactions to transactions in conventional commerce that are addressed in the relevant provisions of national law and international treaties. For example, the purchaser of a digitised image arguably is purchasing the services of the enterprise that purveyed the image over the Internet. Under such a characterization, the income ordinarily would be sourced to the country in which services were performed.<sup>42</sup> Alternatively, the transaction might be viewed as the license to use an intangible, namely, the digitised image that is transmitted over the Internet. Under such a characterization, the income ordinarily would be sourced to the country in which the intangible right was used.<sup>43</sup> Finally, one might view the true nature of the transaction as the purchase of a photograph, economically identical to the purchase of an item of inventory. The problem results from the fact that international tax rules apply very different tax treatments to each of these different categories of income, despite the seeming economic similarities of the example. Under such a characterization, the income would ordinarily be sourced to the country in which title to the photograph passed.<sup>44</sup> Obviously, the proper characterization of a transaction will depend on its particular facts. The point is simply that the characterization of transactions in e-commerce, which have significant implications for the sourcing of income, is a task fraught with difficulties.

A physical book sold from one country to the next creates active business profits that would be taxed in the source country as long as a PE exists. But, as the US Treasury Department notes, a digitised form of this same book may give rise to either sales proceeds or royalties (since copies of the book can easily be made and sold and thus the initial payment represents compensation for the use of a copyright) which, are only subject to (usually low or nil) withholding tax rates in the source country,<sup>45</sup> or perhaps the book is updated from time to time via the Internet and therefore payment for services has arguably taken place. While

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41 OECD Model Tax Convention on Income and Capital, 30 June 1998 (OECD Model Tax Convention).

42 Under the OECD Model Tax Convention, this would depend in part, on whether the services are effectively connected with a permanent establishment or are attributable to a fixed base in the country where the services are performed. OECD Model Tax Convention arts. 14, 15.

43 Under the OECD Model Tax Convention, this would depend in part, on whether the royalties are effectively connected with a permanent establishment or arise from a fixed base in the country in which the royalties arise. OECD Model Tax Convention art. 12.

44 Under the OECD Model Tax Convention, this would depend in part on whether the 'business profits' from the sale are 'attributable to' a permanent establishment in the country where title passes. OECD Model Tax Convention art. 7.

analysing the transactions involving digitised information, the US Treasury Report suggests that the form of transaction may have to be disregarded. For example, where computer software is sold on Internet with a right to make a copy, mere right to copy may be disregarded in view of the ease with which number of copies can be made. However, if such a right to make copies is accompanied by a right to sell to public, royalty will arise. On the one hand, it may be arguable that some of these transactions, such as the electronic purchase of a digital book, are merely substitutes for conventional transactions involving physical objects and that it would be inappropriate to treat them as creating royalty income. On the other hand, it is arguable that the transactions could involve considerable differences in substance; for example, a consumer purchasing a physical copy of a book is usually unable to manipulate the data in the book, while a consumer downloading a digital copy of the book will be able to alter its format, manipulate the data. Whether, and to what extent, the definition of royalties needs to be adapted needs further consideration.

Digitised information also poses problems for the definition of services income, as distinguished from sales of goods income or royalties. Previously a reference work, such as an encyclopaedia, would have been sold as a set of bound volumes and the sale of the bound volumes would have resulted in sale of goods income, notwithstanding the fact that the cost of printing and binding represented only a small fraction of the encyclopaedia's value. Now, instead of purchasing a bound volume, a potential purchaser might be able to choose between a set of CD-ROMs and a computer on-line service through which the encyclopaedia's content can be accessed. If the customer has a sufficiently fast modem connection, there may be little practical difference between accessing the on-line service and the CD-ROMs on the customer's personal computer. Yet the sale of the CD-ROMs still results in sale of goods income while the character of the income arising from the on-line service is not clear. These difficulties were illustrated by the preliminary efforts of the OECD's Technical Advisory Group (TAG) on Treaty Characterization to address treaty characterization issues arising from e-commerce.<sup>46</sup> For example, the Treaty Characterization TAG divided on the proper characterization of electronic ordering and downloading of digital products, where the customer selects an item from an online catalogue, orders the product electronically from a commercial provider, and downloads the digital product on to its hard drive. A majority of the TAG believed that such transaction should be characterized as giving rise to 'business profits' under article 7 of the OECD Model Convention on the theory that the transaction was equivalent to the electronic ordering of tangible products and that the form of delivery should not change the treaty classification of the transaction. The minority, however, believed that this type of transaction constituted payment for 'royalties', and should therefore be treated under article 12 of the OECD Model Convention, on the theory that the substance of the transaction was for the right to copy the program onto the customer's hard drive. The Treaty Characterization TAG addressed twenty-six

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<sup>45</sup> Treasury White Paper at p 23

<sup>46</sup> OECD Treaty Characterization Technical Advisory Group, Characterization of Electronic Commerce Payments under Existing Treaty Provisions, March 24, 2000.

types of transactions in its draft including a variety of transactions involving digital products (e.g., updates and add-ons, limited duration software, and single-use software); application hosting (by means of a separate license and as part of a bundled product); website hosting; software maintenance and other customer support; data warehousing and retrieval; electronic access to professional advice; on-line shopping portals and auctions; and many others. While there was unanimity in characterizing some of the transactions as giving rise to business profits, royalties, or services within the meaning of the relevant treaty provisions, others gave rise to conflicting opinions.

To sum up, the views of the TAG does not necessarily imply unanimity of view amongst all nations of the world. The view is that the different positions taken by countries are in the background of concern for protecting the integrity of their respective tax bases. This concern makes it unlikely that an international consensus would be reached on the issues relating to characterisation of incomes. The possibility of some incomes getting taxed twice or remaining unintentionally untaxed, in both the country of residence and the country of source, cannot, therefore, be ruled out. However, until there is some international consensus as to the characterization of the above concepts, there would be no definite way to determine the source of income, which would result in two possible outcomes. The first would be that both countries, recognizing the ambiguities in the transaction creating the income, fail to characterize the income at all. In this case, the income would go untaxed and neither country would benefit from the tax revenue. In isolated cases, this result would be of little consequence, but if states remain incapable of characterizing income, as e-commerce activity increases, the loss of tax revenue would be significant. The second possibility would arise when both countries would try to manipulate the source concepts to justify exercising their taxing prerogative. Because each State has the sovereign right to tax within its territory, each country can legitimately make a claim to the tax value of that income. However, because of this the taxpayer would be taxed twice for the same activity. This uncertainty would also reduce the incentives for taxpayers to carry on e-commerce activities internationally, which would have the overall effect of stifling this form of economic activity. Because states and businesses have recognized the economic potential of e-commerce, this also would be an undesirable result.

At the heart of the current difficulties is the erosion of the traditional relationship between the service provider's and the service consumer's location. The link has weakened with each improvement in communications technology, such as fax transmissions and e-mail. In an earlier era, the location of the service provider was generally fixed and physically determinable. With electronic information, however, the service provider is mobile and can easily move to a tax haven or a low-taxed treaty jurisdiction. These opportunities for tax planning can ultimately erode the taxable base. At the policy level, I agree to the view that the characterisation of payments should not change with the mode of delivery from physical to digitised form. This will ensure uniformity of approach among all the assessing officers. For the taxpayer, it

would ensure certainty of the tax burden. The only long-term solution of the problems created by characterisation lies in making direct taxation identical for all streams of income in a manner aimed at ensuring equitable sharing of revenues between residence and source countries.

The US suggestion to shift from source-based taxation to residence-based taxation seems to be motivated by its worry regarding revenue collection via the source-based route in the Internet age. This is unlikely, as the US's market share in the retail sector, the dominance of Wall Street, Hollywood, Silicon Valley and Seattle, would enable the US to collect substantial revenue via the source-based route. Australian and Indian proposals pleading for the continuing vitality of source-based taxation deserves serious consideration. *First*, the suggestion that source is tougher to determine than residence due to digitisation seems improbable because of the absence of a widely accepted standard governing the definition of residence. Moreover, source is less elusive than residence, because it is impossible to take Silicon Valley to Monte Carlo. *Second*, it is cheaper to continue with an established standard (source) than negotiating numerous treaties based on a new one (residence). *Third*, residence-based taxation is likely to empower tax havens. This will erode the fiscal sovereignty of all source countries of which produce goods and services that benefit due to digitisation. Revenue authorities should monitor tax collection. The perceived uncertainty regarding the global distribution of revenue can be guarded through an 'escape clause', in the case of drastic shortfall in revenues because of unforeseen happenstance. Escape clauses need to be moderately priced, so that the cost of escape avoids both defection, to be an enduring standard, 'escape' must guard against the easy use of the residence principle (Rosendorf and Milner, 2001)<sup>47</sup>.

PE is the threshold of commercial activity beyond which a firm can be taxed in a foreign country. The OECD has defined automated servers, using a fixed location for a certain period, and performing certain core functions of the firm, to be a candidate worthy of permanent establishment. The traditional understanding is that human intervention is required in addition to the above requirements. While the new definition may benefit server abundant US in the short-run, it would lose in the long run if automated servers migrate to tax havens. PE based on substantial human and financial investment in a foreign country will leave fewer incentives for firms to indulge in tax planning, compared with a situation where automated servers can constitute PE. Server scarce countries are likely to oppose automated servers being defined as PE. India and the UK have opposed this move. Source-based taxation along with the traditional definition of PE continues to be relevant in the digital economy. Many of the participants in the ongoing debates over international taxation of e-commerce have strongly urged the importance of having a higher degree of international cooperation in this area. During the second half of the twentieth century, there had been a variety of attempts to create international organizations with sufficient authority to propose, though seldom to impose, solutions to problems with substantial international dimensions. The United Nations would be

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<sup>47</sup> Rosendorf and Milner (2001) at pp 829-857

the most obvious example, but the International Monetary Fund (IMF) and the World Trade Organization (WTO) would be more appropriate in this context. However, there is no such organization dealing with issues of taxation. The Committee on Fiscal Affairs of the OECD (the 'CFA') would perhaps be the closest approximation, but many countries that are not members of the OECD. Tanzi (1998) had suggested the formation of a World Tax Organization, which would not have actual authority to impose or collect any taxes but which would be a forum for the collection and reportage of tax data and trends on a world-wide basis, the formulation of basic norms for tax policy and tax administration, and which would provide technical assistance and arbitration services to countries that request it.<sup>48</sup> Some of the substantive suggestions for coping with the global income-taxation of e-commerce would appear to require some form of international organization to make them work. For example, some commentators had suggested that ultimately some type of apportionment approach, similar to that used by the states of the US, would be the only effective way of taxing global enterprise income. One would expect that some international analog of the Multi-State Tax Commission (US) would be a necessary part of any such system.

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<sup>48</sup> Tanzi, Vito (1998) paper given at the 32nd General Assembly of the Inter-American Centre of Tax Administration, Bahia Brazil, in May 1998. Similar view had also been expressed by Central Board of Direct Taxes (2001), *Report of the High Powered Committee on Electronic Commerce and Taxation* (New Delhi: Ministry of Finance).

# Chapter-6

## EFFECT OF E-COMMERCE ON CONSUMPTION TAXATION

### INTRODUCTION

In many respects, the most pressing problems of taxation of e-commerce are those raised by consumption taxes. As the number of individual consumers with access to the Internet increases every day, and with more and more products tangible and intangible is being sold over the Internet, the challenges for tax administrations are immediate. OECD has thus observed, "*The problems concerning the application of consumption taxes are generally recognised as having more immediacy than the issues concerning direct taxation.*"<sup>1</sup> This chapter will discuss the principal challenges raised by e-commerce for consumption tax regimes.

In order to examine the impact of e-commerce on consumption taxes, it is essential to distinguish between national and sub-national consumption taxes, more particularly, between VAT adopted by members of the European Union (EU) and the Sales/use tax in force in the US states. *Although both levies in principle are consumption taxes, and both levies encounter certain common problems raised by e-commerce, however there are also dramatic differences between the VAT and the Sales tax. From US perspective, tax collectors already have a huge difficulty in collecting sales and use taxes from sellers, irrespectively of whether such sales were effected online or offline, from out-of-state sellers those who have no presence there to create 'nexus'. This problem arose from the principle enshrined in the 14<sup>th</sup> Amendment to the US Constitution which gave a State the right to impose its tax jurisdiction on a person who "purposefully directs its business activity into a State and the what is commonly referred to as the Commerce Clause of the Constitution which prohibits a State from extending its tax jurisdiction to persons that do not have a 'substantial nexus' with that State". The Supreme Court interpreted 'substantial nexus' as the requirement of a taxpayer to have a 'physical presence' in a State<sup>2</sup>. However, the EU position is characterised by the effort that seeks to enforce VAT collections on supplies of digitised products from on-line sellers situated outside Community territory to consumers in a EU Member State. I would first discuss the e-commerce issues raised by VAT and then to turn to the special problems of the US sales/ use tax system.*

## 6.1 VALUE ADDED TAX (VAT)

The implications of e-commerce for VAT are dependent upon the four categories of transactions involving e-commerce. Briefly, *first*, transactions involving business-to-business (B2B) sales of tangible property consummated through electronic means (e.g., the purchase over the Internet of a computer by a business taxpayer from a remote computer vendor). *Second*, transactions involving B2B sales of digital products (e.g., the purchase over the Internet of an electronic database by a business taxpayer from a database vendor). *Third*, transactions involving business-to-consumer (B2C) sales of tangible property consummated through electronic means (e.g., the purchase over the Internet of clothing by an individual from a remote vendor). *Fourth*, transactions involving B2C sales of digital products (purchase of anti-virus software over the internet by an individual).

I have discussed in Chapter-3 that VAT levied in the EU is a destination-based tax which means imports are taxed and exports are zero-rated and thus tax-free this description is not the case with services. The discussion in the following sections focuses on how the destination principle is actually

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1 OECD Committee on Fiscal Affairs, *Electronic Commerce: A Discussion Paper on Taxation Issues* (1998) (OECD E-Commerce Discussion Paper)

2 The 1992 case *Quill Corp. v. North Dakota* 504 U.S. 298 (1992) established that businesses are not responsible for collecting a use tax unless they have a physical presence or nexus in a customer's home State and the advent of Internet and e-commerce only further complicates the problem.

implemented under the EU's transitional<sup>3</sup> VAT system in the case of tangible products and difficulties in implementing in the case of intangible products.

### 6.1.1 VAT AND INDIRECT E-COMMERCE

The cardinal point in the workings of VAT in the EU is the importance ascribed to the distinction between the delivery of goods and the rendering of services. The review of online commercial activities indicates that it is digital e-commerce<sup>4</sup>, which causes major problem to taxing authorities. While utilizing the opportunities offered by the Internet, the indirect form of e-commerce retains physical forms of distribution, and therefore put much limited pressure on conventional tax concepts built on the physical reality of trade<sup>5</sup>. Distance selling has existed for many years, and there is no difference in principle between a cross-border transaction in tangible goods effectuated by fax or a telephone call than one effectuated by the 'click of a mouse'. However, e-commerce increases the opportunity for cross-border trade, and the increase in the volume of such transactions counsels that attention be paid to existing procedures to assure that they ensure the efficient collection of taxes as well as the speedy expedition of goods to their destination.<sup>6</sup>

As discussed in Chapter-3 the tangible products moving between Member States of the EU are treated differently, depending on whether they are bought by registered traders or by others. In the former case, exports are zero-rated and, under the system of 'reverse charging', purchasers are expected to self-assess the tax of the destination state. Sales from a vendor in one Member State to consumers and unregistered traders located in another (e.g., mail order and telephone sales') are treated differently,

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3 I have discussed about the EU 'transitional' VAT system in Chapter-3. Briefly in 1967, the European Common Market decided that the origin principle should eventually be adopted for trade within the Common Market, (rebate of VAT on exports and collection of VAT on imports) so that the border adjustments required for implementation of the destination principle would not interfere with creation of a single market. In 1987, the Commission proposed a shift to the origin-based system internally by 1993. In 1989, it was realized that the 1987 proposals would not be implemented by 1993; the 'transitional' system was adopted as a means to implement the destination principle for internal trade in goods (Services are taxed on an origin basis as discussed later in the chapter). The key components of this system are reverse charging of VAT on sales to registered traders and collection of tax on distance sales to households and unregistered traders by vendors making substantial amounts of such sales to customers located in a given Member State. Genser, Bernd (2001) 'Coordinating VATs between Member States', presented at a conference on "Tax Policy in the European Union", held at the Research Centre for Economic Policy, Erasmus University, Rotterdam, 17-19 October 2001 as cited by McLure, Charles E. Jr. (2001) 'Taxation of Electronic Commerce in the European Union' Hoover Institution, Stanford University.

4 Also termed as Direct E-Commerce

5 OECD (1997) Electronic Commerce: The Challenges to Tax Authorities and Taxpayers, 4, Nov. 18, 1997, at pp 9-20

Website: [http://www.oecd.org/daf/fa/e\\_com/turku\\_e.pdf](http://www.oecd.org/daf/fa/e_com/turku_e.pdf);

Schenk and Oldman (2000) at pp 489-490;

6 The OECD has pointed out that many Member countries have a *de minimis* standard for low value packages sold by distant sellers that allows them to escape taxation altogether. In the context of a global market in which local consumers can more easily acquire such packages from distant suppliers, the OECD has suggested that Member countries may wish to re-evaluate the *de minimis* threshold to assure that local suppliers are not being harmed by tax-free competition from distant sellers.

OECD Committee on Fiscal Affairs, Electronic Commerce: A Discussion Paper on Taxation Issues (1998) at p 22.

depending on the volume of sales the vendor makes to customers located in the other Member State. If sales fall below the threshold, they are subject to the VAT of the state where the vendor is located. If they exceed that threshold, the vendor must register in the state where customers are located and collect the VAT of that state<sup>7</sup>.

However, this gets more complicated when besides the object itself the transaction also characterised by other rights besides those of physical ownership. Hence, special attention must be given to the VAT treatment of software purchased through indirect e-commerce. The sale of computer software is an ensemble of a number of transactions put into one. A customer is given the right to use the software and in limited cases to make and keep a specified number of copies of the software. The customer would therefore be purchasing the data carrier in a tangible way but would be receiving only rights over the usage of the software and not over the software itself. It is important to understand that due to the peculiar nature of software what is transferred during the sale of a computer programme, whether it is bought off-the-shelf or custom-made to suit individual needs, is it being a good or a service for purposes of VAT.

The principal element in a transaction for the transfer of be-spoke software<sup>8</sup> is not the physical delivery of the medium which contains the programme (later to be used for the installation of the programme on the customer's resident disks) but the development of the software itself. Such a transaction can consist of a multiplicity of aspects: the development of the software and the delivery of the diskettes. In order to determine the nature of the supply to determine whether the object of the transaction for purposes of the Sixth Directive, is a good or a service, depends upon what is considered as being the principal element of the transaction for both the seller and the buyer. As the principal element in the transfer of be-spoke software is the development of the programme, which cannot be considered a tangible thing as defined in Sec. 5 of the Sixth Directive, therefore, the sale of custom-made computer programme is deemed a supply of service<sup>9</sup>.

In the case of shrink-wrapped software after a number of decisions and statements by EU, there is a strong support to the view that the sale of off-the-shelf software<sup>10</sup> should be considered as supply of good. As early as in 1996 a number of countries including Germany and the Netherlands approved regulations, which place the sale of shrink-wrapped software as the supply of goods for purposes of VAT<sup>11</sup>. This view was opposed by dissenting interpretations put forward, mostly constructed on the

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7 EU concluded with respect to the likely increase in purchases of physical goods by private consumers over electronic networks.

Commission of the European Communities, Proposal for a Council Directive amending Directive 388/77/EEC as Regards the Value Added Tax Arrangements Applicable to Certain Services Supplied by Electronic Means (2000) Explanatory Memorandum at p 4.

8 Bespoke or "customized software" is the software, which is tailor-made based on the specific needs of the customer.

9 This was decided in the German case Faabourg-Gelting Linien A/S - Case C-251/94. As cited in Kabisch at p 137

10 'Shrink-wrap software' is the readily available software, which is sold 'off-the-shelf

11 Germany - VAT Directions, German Ministry of Finance at Sec.25 (2)98/620, following the

argument that the principal transaction in the sale of shrink-wrapped software is not the physical transfer of the tangible medium but rather the transfer of some other right, generally the right to use and in some cases to make a specified number of copies of the software.

Under accepted tenets of copyright law, it is not the diskette or CD-ROM which are important in themselves but what they contain and the right to use the software. Moreover, the right to use the software is not contained in the diskette, thus reducing the possibility that the data medium is the principal element in the transaction. Since a consumer buys a computer programme to use it on his computer and this use makes the principal element of the transaction, software cannot be considered a supply of good but that of a service since the right transferred is not tangible or found on the diskette as would be required under Sec. 5 of the Sixth Directive. Unlike books, and music CDs, a computer diskette cannot be used on its own but has to be installed on a hard disk and it is only after such installation that the software can be used. Therefore, the diskette is only a 'data carrier' and only 'ancillary to the possibility to use the software', making the purchase of software the supply of a service in terms of Sec. 6 of the Sixth Directive. As opposed to books and other objects, which can be purchased from a web site, both shrink-wrapped and be-spoke software should be deemed supplies of services and not of goods.

However, a different view was taken by HM Custom and Excise, which defines goods for the purposes of computer software as the physical device upon which information is recorded. By contrast, services are defined as comprising data, programs or instruction.<sup>12</sup> Customs and Excise Notice No 702 provides that where the goods (i.e. the physical form such as a CD-ROM) and services (i.e. the information) are not separately identified the import is to be treated as an importation of goods.<sup>13</sup> If the value of the supply of goods and services are separately identified, VAT is paid on the importation of goods<sup>14</sup>. VAT is charged on the cost or value of the carrier medium. In relation to separately identified services VAT must be accounted for in respect of those services, which were specified in VATA 1994, Schedule 5, on the basis of the reverse charge.<sup>15</sup> Which would normally be the case where the recipient receives the supply for business purposes? The service element of the supply is the information on the carrier, and the charge is for use of the information, which is subject to copyright protection. Both these cases are subject to reverse charge.<sup>16</sup> If a supply is made to a non-business consumer, import VAT is payable solely upon the physical carrier. Since normalised software is typically regarded as a supply of goods, this would mean that supplies to countries outside of the member states of the EU, would typically be zero-rated.<sup>17</sup> The supplier under these circumstances would be entitled to recover all its VAT incurred on the components in making the supply. It is perhaps still too early however to speak in definite terms

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deliberations of the 30th and 38th sessions of the EU VAT Committee.

<sup>12</sup> HM Customs and Excise Notice No. 702/4/94, para. 2.1

<sup>13</sup> Ibid para.3.2

<sup>14</sup> Ibid

<sup>15</sup> VATA 1994, s 8, sch 5.

<sup>16</sup> VATA 1994 Sch5 para. 1 and 3

<sup>17</sup> VATA 1994, s 30

as regards the categorisation of shrink-wrapped software however because of contradictory views and more importantly the absence of a corpus of court decisions in the EU.

### 6.1.2 THE VAT AND DIGITAL CONTENT

The digital environment of direct e-commerce causes problem for VAT system in three ways. The *first*, problem is related to the exponential growth in the number of cross-border business-to-consumer transactions.<sup>18</sup> VAT systems were designed with the assumption that business-to-consumer transactions would predominantly take place within national boundaries. The emergence of mail-order systems did increase the cross-border transaction<sup>19</sup> but it still had not resulted in such a boost of international business-to-consumer transactions, as did e-commerce. As a *second* problem, Hinnekens (1998) argued that direct e-commerce questions the classification of supplies as goods or services. Within the sphere of e-commerce, where electronic transactions compete with physical forms of supply, the goods, originally supplied through conventional channels become digitised<sup>20</sup>. Upon digitisation, the products lose physical appearance; therefore, the regime governing the taxation of goods cannot be applied anymore<sup>21</sup>. The question therefore is how to tax these supplies or whether to tax them at all. The same doubts arise with respect to new types of digital supplies<sup>22</sup>. In addition, new types of transactions are difficult to fit into the existing lists of goods and services to which different rules are applicable under the present systems of VAT<sup>23</sup>. The concepts of fixed establishment, use and enjoyment, location of property, the place where services are performed and distance covered by transport was developed for tangible goods and services developed in a different technological era. *Thirdly*, tax administrations are overwhelmed by the evasive nature of online commerce. Under all existing VAT systems suppliers need to tell the tax status and the location of their customers if they wish to discharge their administrative and payment obligations properly<sup>24</sup>. Accordingly, enforcement in lack of voluntary compliance is based on the authority's knowledge of the identity and geographical data of the supplier<sup>25</sup>. Based on the anonymous series of digital signs representing the transactions it is almost impossible to identify and locate the supplier and the customer<sup>26</sup>.

The VAT distinctions among e-commerce activities are not purely academic. There are several differences between the treatment of goods and services, throughout the VAT system. Differences may involve a taxable event (e.g. import from non-EC supplier applies to goods and not to services), the place of taxable supply (e.g. intra-community acquisition deals with goods and not with services),

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18 OECD, Report On The Turku Conference at p 17

'Explanatory Memorandum' to the Proposal for a Council Directive amending the Sixth Directive as regards the value added tax arrangements applicable to certain services supplied by electronic mean (COM (2000) 349 final) June 7, 2000, pp 6-7

19 Coopers and Lybrand (1998) at p 2

20 Hinnekens (1998) at p 55.

21 Hinnekens (1998) at p 55

22 Houtzager and Tinholt (1998) at pp 99-102

23 Supra note 43 at p 57;

24 OECD (1997) Report on the Turku Conference, at pp 9-12;

25 Ibid at pp 9-12; Explanatory Memorandum, at pp 9-11.

exemptions (e.g. distance selling rule applies to goods and not to services), formalities (e.g. reverse charge procedure applies to services and not to goods) and applicable rates (e.g. zero-rate may apply to books in printed form but not in digitised form). It is important that for these differences distinction be made between services according to their type. For different services, there are different VAT rules, particularly with respect to the place of supply. In the following sections, discussion would focus on these functional problems along with theoretical and practical weaknesses of the Sixth Directive in handling inter-jurisdictional digital transactions.

#### A. Supply of Goods or of Services

The first issue to be decided by the Community was whether the Sixth Directive should tax digital services at all. The goal of Sixth Directive was to levy VAT as broadly as possible<sup>27</sup>, so the answer should be positive because apart from the usage of a new medium, digital supplies have all the characteristics of a taxable transaction<sup>28</sup>. They are affected for consideration, supplied by businesses registered for VAT purposes to businesses with the same status and to final consumers. In addition, these supplies represent a benefit that forms an increasing portion of the GDP<sup>29</sup>. The next question is whether these supplies are capable at all of fulfilling the criteria of the definition of either goods or services. Some authors like Houtzager (1998) concluded that all Internet transactions should be treated as supply of goods. Central to this categorisation is the tangibility of the product and its transfer to the consumer as owner, as is required under Art. 5 of the Sixth Directive. These commentators justify their interpretation on the inclusion of 'electricity and like' in the definition of 'goods' in the Sixth Directive. However, the reason why trade in electronic current is regulated under the rules on goods is not its 'tangibility', but because of the fact that the authorities usually closely control such activity, as provision of public utility, therefore its trade route is transparent enough to apply the place-of-supply rules for goods. This cannot be said about electronic deliveries. Their very nature would render taxation impossible under the regime designed for taxing the supply of goods.

The European Court of Justice seems to hold the view that characterisation of a good or service should not depend on the mode of distribution. In the *Datacenter* case, it found that the mode of distribution

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26 Report by the Technology TAG of the OECD, (2000) on the technological questions of tax collection

27 This has been the goal of the European VAT system since the issuance of the First Council Directive: The Preamble of First Directive. First Council Directive on the harmonization of legislation of Member States concerning turnover taxes (67/227/EEC) OJ 071 14/04/1967 This intention has also been reinforced by Article 2 of the Sixth Directive.

28 OECD (1997) Report on the Turku Conference, at pp 4.

OECD (1998) Taxation Framework Conditions at pp 3

29 E-commerce is predicted to rise to between 4% and 7% of the GDP in the UK, Germany, Italy, and France by 2003.

As mentioned in UK Online (2000) 'Where Does the UK Stand Now?'  
website: <http://www.e-envoy.gov.uk/2000/progress/anrep1/030.htm>

was irrelevant for purposes of defining tax-exempt services<sup>30</sup>. The European Commission back in 1998 proposed the following uniform guideline<sup>31</sup>:

*"A supply that results in a product being placed at the disposal of the recipient in the digital form via an electronic network is to be treated for VAT purposes as supply of services () Products that, in their tangible form, are treated for VAT purposes as goods are treated as services when they are delivered by electronic means"*.

In light of the European Council adoption of the Directive 2002/38/EC and Regulation No. 792/2002,<sup>32</sup> EU treats all products that are distributed electronically as services. International consensus behind this interpretation had already come to existence within the OECD framework<sup>33</sup>, which was in favour of classifying these supplies as supplies of services.

## B. VAT and Place of Supply Rules

The VAT rule for supply of goods is the destination principle; the rules for services are more complicated: place of supply can be either where the supplier or customer is located depending on the specific type of service being delivered. Article 9 of the Sixth VAT Directive provides for two categories of place of supply rules: first is based on the identification of the place of business of the supplier or the customer, depending on the service. The second is based on the place of effective use and enjoyment, irrespective of the place of business. This Article pursues the double aim of concentrating VAT revenue to the country of consumption, while preserving administrative feasibility<sup>34</sup>. This twofold objective has resulted in a rather extensive and complicated framework of place-of-supply rules.

The place of supply of a service is under the general rule of Article 9(1), deemed the place of the supplier's business or fixed establishment from which the service is supplied. The expressions '*place of business*', '*fixed establishment*'<sup>35</sup> and '*permanent address or usual residence*'<sup>36</sup> are not defined in the Sixth Directive. The relevance of place establishment under the Sixth Directive was divided between a numbers of sections, namely Art. 9, Art. 17, Art. 21. The general rule, based on the origin principle was

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30 E.C.J. Case C- 2/95, *Sparekassernes Datacenter (SDC) v Skatteministeriet*.

31 'Electronic Commerce: Commission sets out guidelines for indirect taxation,' *EU Business*, June 17, 1998, available at <http://www.eubusiness.com/finance/980617co.htm>.

32 Detail Discussion about the EU Directive and its consequences Chapter-8.

33 OECD (1998) Taxation Framework Conditions. By this document, the OECD countries voted for classifying digital deliveries as services for the purposes of taxation.

34 Terra (2000) at p 57.

35 The concept of fixed establishment is interpreted by Customs and Excise as '*as establishment (including business establishment) form which business activities are carried out and which has both the human and technical resources necessary for making or receiving the supplies of services in question*'

36 Case law that has contributed to elucidate the meaning of permanent establishment for the VAT liability of non-e-Commerce services should assist in defining the parameters also for e-commerce operations. Lambert stresses that the application of principles from non-e-commerce operations to e-commerce business should not be automatic, but only follow a analysis into whether a particular interpretation, building on what was decided on previous occasions by the ECJ, would result in a fair application of Art. 9. This object of the place-of-supply rules has also been acknowledged by the ECJ in *Gunter Berkholz v Finanzamt Hamburg*(1985) 3 CMLR 667. Gaming machines were installed on ferries operating between Denmark and West Germany, the tax authority sought to apply VAT on the gaming machines.

designed to catch business-to-consumer transactions or national supplies to business customers and was based on the already mentioned belief that due to technical limitations supply of services to consumers normally takes place within one country, therefore the supplier, the customer and the consumption are all located within the same jurisdiction. Under this section, the responsibility to account for and pay the tax lies with the business supplier<sup>37</sup>. This rule was in line with the administrative realities of business-to-consumer transactions, since business suppliers are the ones in possession of necessary data and equipment for the discharge of this obligation<sup>38</sup>.

Section (2) of Article 9 laid down special rules with respect to certain services. Most relevant to the conduct of e-commerce is the fact that '*cultural, entertainment, or artistic*' services are taxed where they are performed, and intangible or intellectual services such as copyrights, licenses, financial transactions, and professional consultations are taxed where the customer who receives the service is established. This nature of the services makes the central business establishment of the supplier relatively mobile<sup>39</sup>. Therefore, apart from the intention to realize taxation in the country of consumption as best as possible, this subsection also aims at preventing the suppliers from establishing their businesses in the countries with the lowest tax-rates, which they would probably do, was the general rule applicable<sup>40</sup>. Both *business-to-business* and *business-to-consumer* supplies of the listed services are meant to come under this subsection regardless whether the two parties reside within the borders of the same country. According to this subsection, the business supplier should discharge its VAT responsibilities in compliance with the tax rate and other requirements of the national VAT regime in the country where it carries out its supplies<sup>41</sup>.

Subsection (e) of section (2) contains regulations with regard to intangible services, such as consultancy, advertising, or data processing. Following from their nature, these services are primarily supplied to taxable entities; therefore, they are presumed by the Sixth Directive to be more susceptible to cross-border delivery<sup>42</sup>. Consequently, in case the central businesses of the supplier and the recipient are not established within one Member State, the section stipulates as the place of supply the location of the recipient's business in line with the destination principle. This rule is coexistent with the application of the 'reverse charge' method under which the liability to account for and pay the tax is imposed on the business recipient. The supplier in turn does not have to charge VAT, i.e. the supply is zero-rated in the country of origin. This rule together with subsection (b) of section (1) Article 21 it makes clear that the reverse charge also applies to cases where a taxable person established outside of the Community renders services to a European taxable person<sup>43</sup>. The subsection also applies to instances where the customer regardless of its tax status is established outside of the European Community. This solution naturally follows from the underlying theory of taxing in the country of

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37 Subsection (a) section (1) of 28g of the Sixth Directive

38 Terra (1998) at p 56.

39 Ibid

40 Ibid

41 Ibid at p 75

42 Ibid at pp 155-156

43 Ibid at p 157

consumption. When the recipient of the services listed in subsection (e) section (2) is a final consumer residing in the Community the supply is taxable according to Article 1. The general rule also applies to cases where the supplier and business recipient both have their central businesses within the borders of one Member State<sup>44</sup>. In order to avoid the possibility of double or non-taxation of these services following from the possible manipulation of the place of business or residence<sup>45</sup>, the Sixth Directive contains a provision complementing the preceding place-of-supply rules. According to section (3) of Article 9 national VAT systems may deem the place of 'effective use or enjoyment' of these services as the place of supply, when this place is different from the location of the supplier or the consumer, and when these different rules lead to different results as to the applicability of the Sixth Directive.

As discussed earlier Internet makes it possible for more intangible goods and services to be delivered to customers by suppliers who have no physical presence in the country where consumption takes place. As a result, both businesses and consumers may be able to structure their buying patterns to avoid paying the VAT. The most of the problems seem to follow from the application of section (1) to business-to-consumer transactions more often than it would be justified by the requirement of taxing at the place of consumption<sup>46</sup>. Section (1) was designed to deal with national supplies, based on the already mentioned assumption on the model of transactions to consumers. Despite the fact that this underlying assumption has been set aside by the explosion in the number of private Internet users, section (1) remains applicable in many cases in lack of a better rule. A better rule would be one of the special place-of-supply rules. However, the special rule is applicable only in case of services specifically listed therein and under special conditions stipulated thereby. This interpretation has been acknowledged by the ECJ in the *Dudda-case*: '*In every situation the question which arises is whether it is covered by one of the instances in Article 9 (2); if not, it falls within the scope of Article 9 (1)*'<sup>47</sup>. It follows those new types of services<sup>48</sup> or traditional services supplied in a novel constellation fall under the general rule<sup>49</sup>.

The over-application of the general rule leads to two undesirable consequences. The first of these consequences appears within the Community. Namely, taxing at origin leads to the misallocation of VAT revenues among the Member States under a given pattern of consumption<sup>50</sup>. Moreover, it has the potential of distorting consumption patterns and intra-Community competition by offering the opportunity to consumers to make their purchases from Member States with the lowest VAT rates<sup>51</sup>. It is obvious that, for example as *Coppers* (1998) pointed out that for a Swedish consumer who has the

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44 Ibid at p 155

45 Ibid at pp 220-222

46 Working Paper - 1998, at p 11; Working Paper - 1999, at p 13

47 Case C-327/94 *Dudda v Finanzamt Bergisch Gladbach* (1996) ECR I-4595 Recital 21. Cited in Tera Ben

48 New types of services include, for example, web hosting, web design, online arbitration services, collocation services. Working Paper - 1999, at p 14; Eriksen and Hulsebos (2000) at p 138.

49 Working Paper - 1999, at p 14; OECD, Report on the Turku Conference, at p 17.

50 The Commission in the Explanatory Memorandum to the Proposal has denounced application of the origin principle with regard to cross-border supplies as distorting competition within the Community for the Sixth Directive cited in Terra, Place of Supply in the EC, at p 55.

choice to order supplies from Luxembourg with a VAT of 15 percent the decision to do so will be of no minute keeping the fact in mind that the Swedish rate is 25 percent<sup>52</sup>.

The other undesirable consequence of the overwhelming application of the general place-of-supply rule occurs on the global playing field. In cases of inbound international supply of services not listed by the special rules, the place of supply is deemed to be outside of the Community. Therefore, supplies of these services to European businesses or consumers are not taxable under the Sixth Directive<sup>53</sup>. If the country of the supplier does not have a VAT regime, the service remains untaxed. On the other hand, outbound international supply of the same services is taxable in both cases<sup>54</sup>. Consequently, under the general rule situations may occur where European businesses charge VAT on their supplies to European and third-country customers, while third-country suppliers provide services without tax both within the Community and internationally. This situation is disadvantageous to European businesses on both the European and the international playing field<sup>55</sup>. Moreover, it potentially distorts the pattern of transactions for two reasons. *Firstly*, this situation induces European businesses to supply their services through websites set up in third countries to retain their competitiveness<sup>56</sup>. *Secondly*, due to the difference in prices final consumption will shift to VAT-free international supplies<sup>57</sup>.

The application of the *lex specialis* might cause some problems with regard to digital deliveries. Namely, the place of supply of services listed under subsection (c) of section (2) might be different from the place of receipt or consumption when supplied digitally<sup>58</sup>. This possibility follows from the special features of digital delivery. For example, in cases of receiving music or motion pictures online in one of the Member States, performance thereof might have occurred previously outside of the EC or in another Member State<sup>59</sup>. When the place of performance does not coincide with the place of receipt or consumption there is chance of non-taxation or misallocation of VAT revenues. So far the discussion was focused on theoretical difficulties of the place-of-supply rules of the Sixth Directive governing the supply of electronic deliveries, in the following section will with the difficulties of the practical implementation of these rules within the digital trade environment. It is important to note here that some of these problems were addressed by European community with the adoption by the European Council of the Directive 2002/38/EC applying VAT to digital products.<sup>60</sup>

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51 Ibid

52 Coopers (1998) at p 5.

53 Working Paper - 1998, at p 7; Explanatory Memorandum, at 6; Schenk and Oldman (2000) at 489; David Hardesty (2000) 'EU Proposes New Taxes on Non-EU Sellers in E-Commerce Tax News'

54 Working Paper - 1998, at p 7; Explanatory Memorandum, at p 6

55 Ibid

56 OECD, Report on the Turku Conference, at p 18; Hinnekens (1998) at p 57;

57 Ibid

58 Harmonization of Turnover Taxes, Working Paper of Directorate General XXI, June 8, 1999.

at p 14

59 Ibid

### C. Consumer and Tax Status, Place of Effective Use and Enjoyment

Determination of the tax status of the recipient when necessary is facilitated by the VIES<sup>61</sup>. In the process of verifying the registration number, the supplier and the tax authorities make use of traditional media for the exchange of information. However, in the sphere of e-commerce, the transaction between the supplier and the customer is taking place online. Clearly, the inability of the VIES system to provide online, real time verification prevents the suppliers from fully exploiting the comfort and speed offered by electronic trade and therefore potentially hampers the pursuance of such activity.<sup>62</sup> The location of the customer required to be verified in order to determine the tax status of the customer. For the business purchasers, if the verification process through the VIES system was successful, the location of the business can be inferred from the registration number.<sup>63</sup> In case of final consumers, there is no such supplementary system<sup>64</sup>. While dealing with the consumer during a physical sale, VAT either paid on the spot or was required to let the supplier know address of the customer for purposes of delivery and payment. When ordering online, consumers use electronic mail for communicating with the seller, but e-mail addresses do not provide enough information about the real, physical residence of its user.<sup>65</sup>

The most evident means of finding out their location is to ask the customers to self-declare this information.<sup>66</sup> However, unless underlining this practice with reliable verification buyers might feel tempted by the anonymity of online trade to disclose false information.<sup>67</sup> Despite the diverse efforts to solve this problem, there is still no reliable and feasible means of identifying and locating consumers in

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60 Detail discussion on the Directive is in Chapter-8

61 The VIES was established by Council Regulation on administrative cooperation in the field of indirect taxation (EEC) No 218/92 OJ L024 01/02/1992 p. 0001. It is a common system for the exchange of information on intra-Community transactions for tax purposes. It has been set up for the supplementation of the Sixth Directive after the introduction of Council Directive amending the Sixth Directive with a view to the abolition of fiscal frontiers (91/680/EEC) OJ L376 31/12/1991, On June 14, 2002, the Commission introduced the on-line validation service. The on-line service, which any member of the public can now access free of charge, allows checking of the databases of VAT registration numbers which each Member State maintains as part of the VIES.

DN IP/02/864 'VAT: New Commission On-Line Validation Service Saves Time And Costs For Businesses', Brussels, 14th June 2002. I shall discuss more about VIES in Chapter-8 (online registration)

62 Explanatory Memorandum, at p 7; Jenkins (2001).

On June 14, 2002, the Commission introduced the on-line validation service. The on-line service, which any member of the public can now access free of charge, allows checking of the databases of VAT registration numbers which each Member State maintains as part of the VIES. DN IP/02/864 'VAT: New Commission On-Line Validation Service Saves Time And Costs For Businesses', Brussels, 14th June 2002. I shall discuss more about VIES in Chapter-8 (online registration)

63 subsection (d) section (1) of Article 22 of the Sixth Directive.

64 I shall discuss more on this in Chapter-8 while discussing the Technological constraint in implementation of collection mechanism for VAT on digital sales.

65 Working Paper - 1998, at pp 7, 14; Eriksen and Hulsebos (2000) at p 139; Jenkins (2001) at p 4.

66 OECD (2001) Consumption TAG Report, at p13.

67 It is possible by disclosing false information as to their location; consumers can save significant VAT costs thanks to the differences in the VAT rates of the Member States and third countries. Coopers (1998) at p 128

lack of voluntary compliance.<sup>68</sup> For the time being suppliers might verify disclosed data by using the credit card information requested from the purchaser previous to the conclusion of the contract.<sup>69</sup>

In case of services listed under section (2) subsection (e) of Article 9 establishing the fact that the location of the customer is inside or outside of the Community is not always satisfactory. The VAT systems of Member States that implemented the derogation provided by section (3) of Article 9 require the determination of the place of effective use or enjoyment of these services. If such place is different from the location of the customer, it should be considered as the place of supply to realize taxation at consumption. In the light of the difficulties with establishing the location of the customer, the conclusion that determining the place of effective use or enjoyment is almost impossible within the digital environment may be drawn without a long analysis.<sup>70</sup> The evasive nature of e-commerce necessitates new tools for detecting the flow of digital services through the Internet.<sup>71</sup> In the lack of reliable technological means, the supplier remains dependent upon the information revealed by the customer voluntarily. The invoice is the heart of the EU VAT system.<sup>72</sup> It records information necessary for the proper taxation of a transaction and it is a prerequisite for claiming VAT deduction.<sup>73</sup> In order for businesses to be able to realize the advantages, following from paperless transactions the facilitation of electronic invoicing is crucial.<sup>74</sup> Such an idea, however, is absent from the Sixth Directive. Although Article 22<sup>75</sup> allows Member States to accept this type of invoice, this is clearly an inadequate basis for uniformly implementing electronic invoicing in the Community. Member State legislation already in place in this matter is often solely focused on domestic electronic invoicing.<sup>76</sup> In addition, such rules are generally accompanied by cumbersome administrative requirements.<sup>77</sup>

The above factors have a negative impact on the fulfilment of obligations under the Sixth Directive. As the other side of the coin, these practical deficiencies also undermine the effective enforcement of VAT rules in lack of voluntary compliance.<sup>78</sup> The pieces of information needed by the supplier for compliance are also essential for the tax authorities for enforcement.<sup>79</sup> To recognize and fight infringement of VAT rules, they need to identify the transaction and gather data on the supplier and the customer. It is obvious that without re-tailoring the rules of the Sixth Directive according to the needs

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68 OECD (2000) Technology TAG Report The conclusion of the Report is that work should be continued in the field of defining reliable technology for jurisdictional identification.

69 Explanatory Memorandum, at p 8.

70 Jenkins (1999) at p 4.

71 OECD (2000) Technology TAG Report

72 Tait (1988) at p 279

Final Report on Invoicing, PriceWaterhouse Coopers on behalf of the European Commission, August 23, 1999 at p 4.

73 28h of the Sixth Directive

74 Explanatory Memorandum, at p 4; Taxation Framework Conditions, p 5; OECD, Report on the Turku Conference, p 12; David Hardesty, 'EU Proposes Electronic VAT Invoices in E-Commerce', Tax News 1, 4, Nov. 19. 2000

website: <http://www.ecommercetax.com>;

Eriksen and Hulsebos, (2000) p 138.

75 subsection (c) section (3) of Article 22 of the Sixth Directive.

76 Eriksen and Hulsebos (2000) p 138.

77 Ibid

78 Tait (1998) pp 315-317; Working Paper - 1998, p 13; OECD, Report on the Turku Conference, pp 9-11; OECD, Taxation Framework Conditions, p 6.

of e-commerce and finding the necessary technological means for their implementation, value added taxation of electronic trade remains vague and incidental.<sup>80</sup> The steps taken by the Community to find viable solutions will be detailed in Chapter-8.

**D. VAT liability of ISP**

An ISP gives a private user an IP-address to call to gain access to the web. The access services provided by ISPs can be regarded as the other side of the coin of e-commerce, since companies would be unable to sell their products if nobody was able to connect through to their servers. However, Internet access is not the only service provided by ISPs. ISPs spend a considerable amount to purchase the technology and hardware to enable them to offer access to the Internet. ISP also provides ancillary services, which include e-mail, web site hosting, the assignment of domain-names and the creation and maintenance of chat-groups and news-groups. If these services were provided in exchange of payment then the ISP would be liable to collect VAT from customers according to the rates applicable in each Member State. In the supply of products by ISPs, there is nothing, which can be tangible; hence, for the purposes of the Sixth Directive such transactions shall be deemed to fall under the definition of services and not of goods. ISP provides 'access to global information networks' and therefore by virtue of Sec. 9 (2e) of the Sixth Directive belongs to the definition of telecommunication services following an amendment in June 1999. The amendment to Art. 9 by means of 1999/59/EC was partly inspired by the fact that non-EU companies offering telecommunication services to Community residents had an advantage over their EU competitors. Before the coming into force of 1999/59/EC ISP services were taxed under the general rule found in Sec. 9 (1) under which the place of establishment of the ISP, or rather the country where it would be registered for VAT, would be considered as the place of supply for taxation purposes. To address the competitive disadvantage suffered by European ISPs, particularly about services rendered to non-taxable individuals and enterprises, in March 1997 the Council allowed Member States to derogate from the rule under Sec. 9 (1)<sup>81</sup>. In order to protect the commercial interests of ISPs operating within their national territories in a matter of a few months all Member States had implemented 97/203/EC<sup>82</sup> but it was evident that a more clear and definitive answer to this question should be sought, thus laying the grounds for the introduction of the definition of telecommunication services under the exceptional rules to the place of supply of services in Sec. 9 (2). With the enactment of 1999/59/EC, the scope of these derogations, an interim arrangement, was fulfilled. Finally, 1999/59/EC opted for the reverse charge system through Sec. 21 (1b) for telecommunication services introduced by Sec. 9 (2e). By means of the new Sec. 9 (4) EU, members could change the determination of the place of supply by virtue of Sec. 9 (3b) in the case of services to non-taxable persons in the EU by non-EU ISPs when such services are 'effectively used or enjoyed' in Community territory. Sec. 9 (3b) however can only be applied in the case when the services were supplied to 'non-

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79 Ibid

80 Ibid

81 European Council Decision of the 17th March 1997, 97/203/EC.

82 Taylor and Ogely (1997)

taxable persons established<sup>83</sup> and not necessarily to EU residents only. This presents a much wider net for VAT taxation including non-Europeans using or enjoying ISP services of non-EU providers while passing through Community territory. It was argued that also this could potentially have double-taxation implications<sup>84</sup>. As regards ISPs, a final point raised by Kabisch could be discussed. If an ISP provides ancillary services besides the access to a 'global information network', such as would be separate special support services which however are charged separately, the tax rate that should be levied is determined with reference to the rate that would be applicable for the principal element in the transaction, in this case access to the Internet. Some types of paid-for support services would clearly not fall under the definition of 'telecommunication services'. An analogy could be drawn with an ECJ judgement<sup>85</sup> in which the court decided that the place of supply of a composite service was to be determined according to the place of supply of the dominating supply in the transaction. Following this line of thought therefore ancillary services supplied by ISPs in connection with the access to the Internet offered to customers should be viewed as falling within the parameters of the definition of telecommunication services, albeit indirectly.

## 6.2 SALES TAX

The discussion earlier in chapter-3 about the nature of the retail sales tax provides an overview of the constitutional restraints that are imposed on its implementation in relation to the out of state sales. US jurisprudence regarding federal taxation of out of state transactions began to emerge in 1941. In that year a Mexican radio station broadcasting from near the U.S. border persuaded U.S. federal courts that it should not have to pay U.S. income tax on its advertising revenues obtained from U.S. customers<sup>86</sup>. In accord with that precedent, the U.S. taxing authority (Internal Revenue Service or IRS) refrained from taxing mail order sales originating outside the U.S. and directed to U.S. customers<sup>87</sup>(Thomas, 2001). The authority of U.S. state and local governmental entities to tax mail order sales originating from outside the taxing authority's jurisdiction have also been limited. Presently, for instance, an US state may not levy a sales or use tax on a mail order transaction originating from outside the state and directed to a customer within that state, unless the tax is imposed on the in-state customer rather than on out-of-state seller<sup>88</sup>. The practical problems with identifying those customers and collecting the tax are so great as to discourage almost all effort to impose the tax.

This virtual U.S. tax exemption for out of state mail order transactions can easily be extended by analogy to e-commerce; similarly, state and local taxing authorities find out-of-jurisdiction e-commerce sales no more readily taxable than counterpart mail order sales. Indeed, one could view e-commerce

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83 Sec. 9 (4) Sixth Directive.

84 Lejeune, Vanham, Verlinden and Verbeke (1998)

85 Faaborg-Getling Linien A/S, European Court of Justice Case C-251/94, which dealt with the provision of catering services on board a passenger ferry.

86 *Piedras Negras Broadcasting Co. v. Commissioner*, 43 B.T.A. 297 (1941) *nonacq.* 1941-1 C.B. 18, *aff'd*, 127 F.2d 260 (5th Cir. 1942).

87 Treas. Reg. § 1.864-4(b) Example (3) as cited by David Thomas (2001) 'Current Issues in US State and Federal Taxation of Electronic Commerce', Paper presented at 16th Annual Conference BILETA (2001)

sales as simply a form of mail order sales initiated through electronic media and completed by the same couriers as used in mail order sales. If one questions why taxing authorities should show so much interest in e-commerce sales when they have been basically content to leave mail order sales untaxed, *"the answer is that, potentially, the dollar volumes involved in e-commerce transactions far surpass anything we have seen in the area of mail order sales."*<sup>89</sup> In addition to potentially enormous volumes of traditional transactions in tangible goods, electronic sales of digitised products and services will soon explode and, in addition, could easily be so positioned as to originate outside the United States. Hence, the use of the Internet changes only the magnitude of sales transactions; it does not change fundamental complexities arising out constitutional restraint on enforcement and collection of sales/use taxes (Thomas, 2001). The discussion in this chapter is not about the issues of fixing the sales and use tax structure, namely, how the states' sales tax regimes can be modified to accommodate massive amounts of economic activity conducted through e-commerce by remote service providers engaged in non-traceable transactions from unidentifiable locations. Instead, the focus of the discussion is on how these restraints limit the states' ability to apply their laws to e-commerce.

Although consideration of various forms of federal legislation to restrain, expand, or otherwise prescribe the way in which states may or may not tax e-commerce are important questions. However, it is more of political will that can obtain national sales tax simplification, rationalization, and restructuring with constraint on local sales tax authority that would reduce compliance burden by giving remote vendors a near uniform sales tax landscape. This is particularly relevant if there have to be a speedy outcome from the state legislative processes. Attaining consensus across states on what the rationalized model will be and then getting individual state legislatures to adopt that 'reform' structure would promise a long struggle and would radically change how state and local tax policy is designed in the US. In principle, an in-state consumer stands nothing to gain by making an out-of-state or interstate purchase free of sales tax, because they will ultimately have to pay an identical use tax when he uses, stores, or consumes the property or services in their home state. If, for example, a Washington resident was to go to Oregon to purchase a car, he would pay no sales tax in Oregon, which does not have sales tax, but he would pay use tax in Washington, equal to the sales tax that he would have paid had he bought the car in Washington.

In theory, this basic sales/use tax regime also applies to transactions in e-commerce in the same manner that it applied to transaction in the above example involving the car. Thus, when a book bought from Amazon.com by a buyer in Georgia, there is no question that the buyer would owe a Georgia use tax equal to the sales tax that he would have paid had he bought the book in a bookstore in Georgia. There is, however, one significant difference between the purchasing from Amazon.com and the purchase of the automobile as described above. With respect to the purchase of the car, the state has a practical means of requiring the purchaser to pay the use tax namely, collecting it upon registration of the vehicle. However, states do not require that consumers register books they purchase. Consequently, unless the consumer voluntarily remits the use tax on the purchase from the out-of-state vendor, the

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<sup>88</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

state has no practical means for collecting the use tax unless it can require the out-of-state vendor to collect the use tax in the same way that it relies on the in-state vendor to collect the sales tax. E-Commerce facilitates transactions between and remote vendors, thus increasing the likelihood of non-payment of state sales and use taxes.

The three factors used in determining whether sales tax liability exists for a retail transaction problems in an e-commerce environment. *First*, regarding the content or substance of the transaction, e-commerce retail transactions mainly involve intangible goods and services. Some intangible goods, like music, which are normally transferred through a tangible medium, as a compact disc, can be delivered also through an electronic medium and avoid classification as tangible good. As long as sales taxes are only imposed on tangible goods, this shift in the type of goods being purchased results in an erosion of the sales tax base and a subsequent reduction in sales tax revenues. The *second* factor, *situs*, the location of the transaction: which is readily determinable in a transaction where a consumer goes to a retail store and purchases a tangible good, the taxing jurisdiction is the state where the vendor's store is located. However, if a resident of one state purchases a tangible good from an on-line catalogue on the Internet from a vendor in another state, to be delivered to someone else in still another state, then it becomes unclear in which state the transaction occurred. A physical concept such as *situs* does not adapt easily to a non-physical environment like the Internet. *Third*, the concept of nexus deals with whether the taxing jurisdiction has sufficient connection to the transaction to have the power to impose a sales or use tax on the transaction or collection duty on an out-of-state vendor (Adams, 1997). Since the buyer and seller need not have direct contact to engage in a transaction over the Internet, a nexus problem may develop if the buyer and seller reside in different jurisdictions. The 'US problem' with consumption taxation of e-commerce has similarity with remote selling. However, for the US and other countries having sales tax the magnitude of the problem is more for e-commerce because of the taxation requirements of digital products. Hence, in the following sections I will be discussing these three issues.

### 6.2.1 SALES TAX NEXUS

'Nexus rules', determine whether a state can tax income or require remote vendors to collect sales tax or pay business activity taxes and acts as a connection between the vendor and state such that subjecting the vendor to the state's sales tax rules is neither unfair to the vendor nor harmful to interstate commerce. These two requirements of fairness to the vendor and no impediment to interstate commerce stem from the U.S. Constitution respectively, from the *Due Process Clause* and the *Commerce Clause*. In *Bellas Hess*,<sup>90</sup> the Supreme Court ruled that, under the Due Process and Commerce Clauses, states could not impose a requirement to collect use taxes on the sale of tangible products on a 'seller whose only connection with customers in the State is by common carrier or the US

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89 Fleming, J. Clifton (2000) 'Electronic commerce and the State and Federal Tax Bases, *Brigham Young University Law Review* at pp 1, 4  
90 386 U.S. 753 (1967)

mail.<sup>91</sup> The Court did not distinguish between the Due Process and Commerce Clauses as foundations for this decision. However, in 1992, in *Quill*, partially overturning the decision in *Bellas Hess*, the Court clarified that the Due Process and Commerce Clauses provide two distinct tests.<sup>92</sup> The first of these requires only some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax. Thus, the Court said,

*"If a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's in personam jurisdiction even if it has no physical presence in the State . . . . Comparable reasoning justifies the imposition of the collection duty on a mail-order house that is engaged in continuous and widespread solicitation of business within a State"*<sup>93</sup>.

It is thus unlikely that the Due Process Clause will provide protection from taxation for a business that purposefully seeks to exploit the market of a state, if its contacts with the state are more than minimal. By comparison, the Commerce Clause requires 'substantial nexus;' mere 'minimum connection' or economic presence in the state is not enough to establish taxable nexus. The distinction between the two nexus requirements is potentially crucial. The Constitution gives the Congress the power to regulate interstate commerce; it does not give it the power to override the constitutional guarantee of due process. Mail-order houses had argued that the physical presence test of *National Bellas Hess* applied to the Due Process Clause as well as the Commerce Clause. If the Supreme Court had accepted this view, it would have made it impossible for the Congress to enact legislation requiring out-of-state vendors to collect use taxes. The Court pointedly said that "*Congress is now free to decide whether, when, and to what extent the States may burden interstate mail-order concerns with a duty to collect use taxes*"<sup>94</sup>.

E-commerce, especially in content, raises interesting questions of Due Process nexus. Presumably, a vendor must intend to exploit the market for nexus to exist. However, what demonstrates intent? Does the mere fact of advertising over the Internet establish intent to exploit a market, and thus nexus, since it is common knowledge that the Internet has no geographic boundaries? At least one decision, not involving taxation, *Bensusan Restaurant Corp. v. King*,<sup>95</sup> suggests that it may not. In this case, the court said that placing an advertisement on a Web site did not establish jurisdiction in the courts of the state where the advertisement is seen. Is intent to market in a given state established unless the vendor explicitly says that it will not make sales to the state, and in fact does not (in which case there would be no issue of liability for collecting use tax, in any event)? Such a rule would be workable and perhaps appropriate in the case of tangible products, where shipping addresses can be used to determine destination of sales. However, how does the vendor implement the intention not to market electronic content in a given state, since there is generally no way of knowing where sales of content is received? (McLure, 1997). McLure Jr (1997)<sup>96</sup> was of this view "*On balance, I am inclined to agree with Bruce Reid of Microsoft who has said (presumably referring to both income and sales taxation): The Quill*

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91 Ibid at p 758

92 *Quill* 504 US at p 306

93 Ibid

94 Supra Note 92

95 937 F. Supp. 295 (S.D.N.Y. 1996), aff'd, 126 F.3d 25 (2d Cir. 1997)

*ruling reduced the Due Process threshold for nexus to such a de minimis level that the protection afforded by that Clause is a virtual myth. Consequently Internet and online service providers, as well as those selling content via the Internet or private online networks, cannot depend upon the Due Process Clause for any protection against state taxing authorities”.*

In light of the preceding discussion, it should come as no surprise that the application of federal constitutional nexus principles to e-commerce is fraught with difficulties. The proposition of finding out if a company has physical presence in a particular state is far more difficult than it seems. For instance, in the case, *America Online v Johnson*, a Tennessee court decided that America Online did not have sufficient physical presence to create nexus, despite the fact that it owned and leased to others a substantial amount of telecommunications equipment in the state. This case has demonstrated the uncertainty involved in determining nexus. However, under the non-electronic physical presence standard for nexus, an on-line vendor that has employees, equipment, or property in a state will have physical presence that establishes nexus in that state<sup>97</sup>. An in-state office or warehouse is not necessary. Even if a business lacks physical presence in a state, that state may be able to claim taxing jurisdiction through the activities of a third party that are attributable to the business. This principle has been established in *Scripto v. Carson*<sup>98</sup>, where the Supreme Court held that an out-of-state seller could be required to collect and remit use tax in Florida based on orders that its independent sales representatives solicited for it in that state. The presence of sales representatives, and of technicians performing occasional repair or installation services, and providing on-site technical advice or support will create nexus for both corporate income and sales and use tax purposes. Similarly, a computer software company that sends its representatives into a taxing jurisdiction to conduct business activities, such as the design and creation of a home page, may also be creating nexus in the taxing jurisdiction. If an employee is permanently located in a state, and works out of a business location of the taxpayer, the employee likely causes nexus. It should not matter what the employee does, so long as the employee works out of the employer's business location. However, as Hardesty (2001) has pointed out that there is some disagreement on this question. Most of the decided cases relating to employees in a state involved salespeople. Some have concluded that only a salesperson in a state can cause nexus. However, there seems to be little support for this notion.

Some level of negligible or 'de minimis' physical presence in a state will not create taxable nexus. States have taken a very narrow view of what amount of physical presence will be considered negligible to safeguard their revenue base. The New York Court of Appeals, in *Orvis Co. Inc. v. Tax Appeals Tribunal*<sup>99</sup> and *Vermont Information Processing Inc. v. Tax Appeals Tribunal*,<sup>100</sup> held that sporadic visits by a mail order company's sales personnel for the purpose of soliciting orders from retailers, and occasional visits by a computer software and hardware developer's personnel to install software, train employees, and correct difficult or persistent problems, were sufficient to satisfy the

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96 McLure Jr (1997) at pp 322-31

97 *Quill and National Bellas Hess*

98 362 US 207 (1960)

99 *Orvis Co. Inc. v. Tax App. Tribunal*, Docket No. 138 (N.Y. Ct. App. 1995);

substantial nexus standards of *Quill*<sup>101</sup>. Questions regarding 'de minimis' activities arise not only with the presence of employees in the taxing jurisdiction, but also with the location of certain kinds of property in the state. For instance, a taxing authority may argue that a computer company that sends dozens or hundreds of floppy disks containing its software into a state may be deemed to have sufficient physical presence in the state.

The same questions about 'de minimis' physical presence also arise with property in the state. In *Quill*, the out-of-state mail-order company also licensed software to some of its North Dakota clients. According to the Court, '*although title to a few floppy diskettes present in a State might constitute some minimal nexus ... [the Court] expressly rejected a 'slightest presence' standard of constitutional nexus.*' Accordingly, the Court concluded that *Quill's* licensing of the software in that case did not meet the substantial nexus requirement of the Commerce Clause. Because the Court did not define what would constitute more than a few disks, some states may argue that the presence of a substantial amount of licensed software creates substantial nexus under *Quill*. In this regard, it is unclear whether states will make a distinction between 'canned' (i.e., not customized) software that is licensed (essentially 'sold') to in-state customers for personal use or consumption differently from software sent to the customer to permit the remote vendor to commercially exploit the market state where the customer is located. It is common practice for on-line service providers to ship thousands of 'free copies' of software to consumers around the country so that the consumers can begin to access their commercial on-line services or information databases.

Tennessee court, in *AOL v. Johnson*<sup>102</sup> held that, there is "no authority that supports a finding of substantial nexus based upon the physical presence in the state of equipment leased to, or leased by, the taxpayer." The court meant, by this statement, that personal property alone does not result in nexus. Indeed, the court seemed to work from the assumption that nothing short of employees, agents, or business premises in a state will cause nexus. The case has received some negative comments; with some experts wondering if the court simply got it wrong and the appeal is pending. However, the surprising result of this case highlights the difficult determinations in applying the physical presence rule. For companies engaged in e-commerce, the question of personal property will most likely come up in the context of the presence of a company's equipment, Web server, or inventory in a state.

One of primary issue in relation to online sellers is the effect of a Web server in a state since every company needs a server, and it is often necessary to use a server in another state. The issue is important

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100 Vermont Info. Processing Inc. v. Tax App. Tribunal, Docket No. 139 (N.Y. Ct. App. 1995).

101 In *Orvis*, employees who did not live in New York visited customers at least 12 times over a 3-year period. In *Vermont Information Processing*, the taxpayer's personnel made 30 to 40 trips into New York over a period of 3 years. The New York Court of Appeals held that while a physical presence of the vendor is required under *Quill Corp.*, it need not be substantial. Rather, the presence must be more than a "slightest presence" and may be manifested by the presence in the taxing state of the vendor's property or the conduct of economic activities in the taxing state performed by the vendor's personnel or on its behalf.

102 *America Online, Inc. v. Johnson*, Docket: No. 97-3786-III, Tenn. Chancery Ct. (3/13/01).

enough that several states have issued guidance on the effect of a Web server in a state. CCH<sup>103</sup> a major publisher of tax related materials, in a recent survey of state tax administrators, asked them whether nexus would result from the presence of a website on a third party Web server in the state showed that while a number of states did not answer the question, or indicated that they were not certain of the answer, no state said yes. Web sites arguably are electronic advertising or intangible property. However, some states may argue that those sites that are located on a third-party computer server in the state and for which a monthly or annual fee is paid, constitute leases of tangible personal property (e.g., the computer). As such, they could be said to create a physical presence in the state. This is particularly problematic because vendors with web sites may not know the location of the computer server(s) they 'rent' from third parties. Hence, under the theory of attributional nexus, even if a corporation *itself* does not have sufficient presence in a taxing jurisdiction, the jurisdiction may assert nexus by attributing the presence or activity of another person or entity to the corporation.<sup>104</sup> In the CCH survey, mentioned above, tax administrators were asked if nexus would result where a website was hosted in a state, and the hosting company also provided services, such as design, advertising, or order processing. A number of states answered this question 'yes'.

Where a company operating retail stores in many states opens a website to serve the same customer base were owned and operated by the same corporation, it would likely have sales tax nexus in any state in which a store is located. However by using separate corporations, a company apparently hopes to use 'entity isolation' to avoid nexus. Whether it will work in the case of particular online company depends entirely on the actions of the two corporations, and especially on services performed on behalf of each other. According to the 'entity isolation' strategy, a retailer with stores in most states avoids nexus for its online company by placing it in a separate corporation. If the corporation operating bricks-and-mortar stores is operated separately from the one operating the online store, the presence of the stores in the states should not be attributed to the online company, and will not cause it to have nexus. For this strategy to work, the separate corporations must be operated separately. For instance, the physical stores cannot be agents or representatives of the online store.

Merchandise returns can result in nexus, where a store is shown to be the agent or representative of an online company. Indeed, in California's assertion of nexus against 'Borders Online', returns of merchandise to 'Borders Books' stores are reportedly the primary basis for the state's claim<sup>105</sup>. Whether nexus exists because of merchandise returns, however, depends on the motivation of the store in accepting returns. A store may be acting on behalf of the online company in accepting returns, in

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103 Sales and Use Taxation of E-Commerce – State Tax Administrator's Current Thinking with CCH Commentary, (CCH, 2000) As cited in Hardesty (2001)

104 *Scripto Inc. v. Carson* 362 U.S. 207 (1960) The U.S. Supreme Court held that Florida could require an out-of-state seller to collect use tax on orders solicited on its behalf in Florida by independent contractors. Scripto, the seller, which was based in Georgia, had 10 independent contractors conducting continuous local solicitation in Florida and forwarding the resulting orders from Florida to Georgia for shipment of the ordered goods.

105 Hardesty, David, 'California to Assert Nexus Against Online Bookseller', EcommerceTax.com (7/22/01) (<http://ecommercetax.com/doc/072201.htm>).

which case nexus is likely to result. However, if it acts on its own behalf, it cannot be said to be the agent or representative of its affiliate, and there is no nexus.

It important to note that with substantial online sales there will be need for a convenient way to return unwanted goods. What can possibly be more convenient than a local store affiliated with the online company; especially, if the online store tells the buyer exactly where to find a local store? One of the reasons why states lost their bids to assert nexus in the mail order cases was that the numbers of returns to stores were relatively minor. The courts cited the inconsequential financial impact of the returns, though they did not give an indication of the effect of a larger number of returns. Hence, a court may find that a large number of returns indicate, on its face, that a store is the agent or representative of an online company. Even if the court does not accept this view, a large number of returns accepted by a local store can act as an indication that the store is part of an integrated retailing operation, that includes its online affiliate, and that the store is not acting on its own behalf. On its face, this appears a strong argument that stores act on behalf of the online affiliate in accepting returns, thus creating an agency or representative relationship, and nexus.

Unlike most products, sellers of computer products require a relatively high amount of service. Because it would not be practical for customers to ship a computer to an out-of-state seller for servicing, sellers often arrange with local companies to provide their customers with warranty services. The Multistate Tax Commission (MTC) argued that contracting with a third party to provide warranty repair services in a state creates substantial nexus. An important point in analysing nexus from in-state warranty services are, often it is the manufacturer, not the seller that provides the warranty. If warranty services are arranged for and paid for by the manufacturer, it seems doubtful that warranty service providers can be agents of the seller. This should let most online sellers off the nexus hook, since they do not sell their own branded products, and do not offer their own warranties. Hence it is clear under existing law that states possess the constitutional power to impose a tax on the in-state the use, storage, or consumption of digital or non-digital products sold over the Internet. It is equally clear, however, that states lack the constitutional power to require a non-physically present, out-of-state vendor of digital or non-digital products to collect use taxes that a state may seek to impose on the in-state use of such products. As a consequence, any use taxes that a state may impose on Internet-related transactions involving non-physically present vendors are likely to go uncollected, just as use taxes that are legally due on many interstate mail-order sales currently go uncollected.

### 6.2.2 TAXABLE SALES

Current state sales taxes were designed for a world in which local merchants sell manufactured products. Thus, they apply primarily to *tangible* products; in general, they do not apply to *services*, except on a selective basis, or to *intangible* products. The first and most obvious issue in the debate over taxation of e-commerce is whether sales taxes should apply to services and intangible products delivered over the Internet (and presumably to similar products delivered in other ways). If not, the

burgeoning of e-commerce raises a second question: how to distinguish taxable and exempt products in a world in which traditional distinctions are becoming blurred? If the tax net is widened to include services and intangibles, a third question arises: whether these products should be exempt when bought by businesses? However, the most basic question also remains whether e-commerce is taxable at all. The answer to the question would be relatively straightforward if the states had made a deliberate legislative decision in this regard. That they have failed to do so is due not to any Hamlet-like ambivalence over the question 'To tax or not to tax?' but rather to the simple fact that, in many instances, states have not addressed the question specifically. Moreover, since much of e-commerce involves the sale of services rather than the sale of goods, transactions in e-commerce are likely to be characterized as non-taxable unless they fall within one of the selective categories of services that the states, to a varying extent, have decided to tax. Consequently, taxpayers and tax administrators are forced to struggle with the question whether transactions in e-commerce fall within the definition of taxable 'telecommunications services,' 'data processing services,' 'information services' (Hellerstein, 1997a).

Hence, the starting point to determine the tax consequences of transactions in the electronic marketplace is to properly characterize the transaction based on its particular facts and circumstances. This determination is critical because differing characterizations could result in different applications rules that could in turn, produce different tax obligations. The most significant feature of existing state sales tax laws insofar as they apply to e-commerce is that state sales taxes generally apply only to sales of tangible personal property and not to sales of services or of intangible property. While a few states tax a wide range of services (including information and data processing services), and most states tax some services (e.g., public utility services and hotel and motel services), most state sales taxes are limited to sales of tangible personal property. What impact does the limitation of most states' sales taxes to transfers of tangible personal property have on the application of the current sales tax law to e-commerce? Essentially, what it means is that most states currently seek to tax a very small portion of the transactions that constitute e-commerce. As mentioned before, if e-commerce is divided into two broad categories the transactions involving sales of tangible personal property acquired over the Internet and transactions involving sales of digital products, it is only the first category of transactions that generally falls within the scope of the states' sales taxes. Thus, if someone buys a book from Amazon.com by clicking on its Web site or a laptop from 'Dell.com' by clicking on its Web site, it is clear that most states will seek to tax that transaction. On the other hand, if someone buys software over the Internet, or orders plane tickets over the Internet, trades stocks over the Internet, or enrolls in distance learning courses over the Internet, none of these transactions would be subject to tax in the overwhelming majority of states.

Four states, New Hampshire, Oregon, Montana, and Alaska, do not impose a state level sales tax. The remaining states tax most tangible goods, and exempt from tax most services. However, state-by-state differences in what is taxable and what is not make it necessary for sellers to research each state's tax rules for the status of their particular products or services. Hence, issue that arises in this context is the

meaning of the terms 'tangible' and 'intangible'. Thus, 'tangible personal property' is defined as personal property, which may be seen, weighed, measured, felt, or touched or is in any other manner perceptible to the senses<sup>106</sup>. The statutory definition incorporates a common law (and common sense) concept of 'tangible' as perceptible to the senses. Thus, tangible personal property does not include contractual rights and other property rights, even though such rights are evidenced by documentation, which is tangible. This is consistent with the traditional common law concepts of tangible property in which the rights actually possessed are not the physical documentation but the 'intangible' contractual rights and property rights represented by the documentation. The statutory distinction between 'tangible' and 'intangible' has been relatively easy to apply in the sales tax arena. Advances in technology, however, have done much to blur this line between tangible and intangible property. The most troubling aspects of taxation of products sold online is the uncertainty regarding the taxability of digitised products, such as books, software, videos, or recorded music. Currently, seventeen states tax content that is transferred by electronic means<sup>107</sup>. These jurisdictions tax a variety of electronic services, including, e-mail, data processing, computer bulletin boards, news and weather reports, credit reports, airline reservations, cable television, fax services, the sale of software, 900 phone number services, and the like.<sup>108</sup> However, they differ in their approach to taxing *on-line* sales. Some tax them as part of the sales tax imposed on tangible personal property; others tax them as a separate category of services.<sup>109</sup>

The question presented is whether products that are clearly tangible personal property when delivered physically remain tangible personal property when delivered electronically. Is text displayed on a computer screen really the same thing as a printed book? Is a movie downloaded to a computer hard drive really the same as a video rental? The answer is not obvious. For instance, mass produced (canned) software purchased online and delivered through the mail is clearly tangible personal property, and is usually subject to sales tax. Is the same software tangible personal property when a customer downloads it from a website? State tax authorities have struggled with the characterization of downloaded software for a number of years. When sale of software can be regarded as tangible and when it can be regarded as intangible?

A sale of shrink-wrapped, or canned, software is usually considered a sale of tangible personal property. Almost all states subject sales of canned software to sales and use tax. On the other hand, custom software is usually considered as not tangible property. In most cases, it is considered as 'services'. In states that subject services to sales tax, custom software may be taxable. Shrink-wrapped or canned software delivered electronically may be considered the sale of tangible or intangible

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106 "Tangible personal property" does not mean stocks, bonds, notes, insurance, or other obligations or securities

107 These states include Alabama, Arizona, Colorado, Connecticut, Idaho, Iowa, Louisiana, Maine, Mississippi, New Mexico, New York, Ohio (for commercial purposes only), South Dakota, Texas, Utah, and Washington. A survey of the various taxes that states impose on the Internet can be found at Vertex Inc.'s web page, Internet Taxation & State Summaries <[http://www.vertexinc.com/taxcybrary20/cybertax\\_ channel/taxtable&uscore; 72](http://www.vertexinc.com/taxcybrary20/cybertax_channel/taxtable&uscore; 72)> The District of Columbia also levies such a tax.

108 Frieden and Porter (1996)

property depending on the state in which it is sold. States have different rules regarding the liability to collect sales and use tax on canned software, which is transferred electronically. In Texas, the sale of canned software is taxable as tangible personal property contained on "electronic media." Pennsylvania taxes the sale of a license to use canned software as a sale of a computer service. Illinois taxes the electronic transmission of software. Illinois has specific language in its sales and use tax rules that say the sale of 'canned software' is subject to sales tax regardless of how the software is transferred. Some states do not tax electronically transferred software, even though they may tax the same software sold in a box. California, for example, will not tax canned software if it is transferred electronically from the seller's place of business, to or through the purchaser's computer, and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction.

The status of new products, such as electronically delivered books, videos, and music has yet to be addressed by the states. The New York Department of Taxation and Finance while replying a petition for an Advisory Opinion from Universal Music group, wanting to know, if it the music provider is subject to sales and consumer's use tax when an item from its music catalogue is downloaded via the internet, relied upon the *New York State Tax Law*, sections 1105 (a) and 1110 (a)(A) for the proposition that "*sale of digitised music recordings over the internet constitutes the sale of intangible property and is not subject to sales or compensating use tax*". This opinion cited *The Stock Market Photo Agency, Inc*<sup>110</sup>, which held that the taxpayer's "receipts from the electronic transfer of digital photographic images over the internet represents receipts from the sale of an intangible and are not subject to sales tax". The Department also ruled that information and entertainment services are not considered taxable services when distributed via Internet. It is generally accepted that tax rules for the sale of intangible products and services should be the same, as those for other goods—that means of delivery should not govern tax treatment. Such 'technologically neutral' taxation would not treat the sale of a paperback book any differently than the sale of a digitised book, to use one oft-cited example. On the other hand, determining which products are functionally equivalent is a tricky proposition.

States exempt most services from sales and use tax. However, what happens when property and services are bundled together. Should the result be different, depending on whether an online service 'transmits' information for others or 'sells' the same information? Even states that employ an inclusive definition of transmission must distinguish between transmission and sale of information content. The fact that online service providers (and ISPs) typically (and increasingly) 'bundle' transmission services and content further complicates matters. (At times, if non-taxable services are bundled with taxable services, both are subject to tax, unless the prices are stated separately.) Even if it were practical to unbundled charges for various services, results would probably be extremely arbitrary and subject to manipulation, and thus litigation. In Texas, the term "taxable information service" refers to information that is gathered or compiled and made available to the public. Services unrelated to the information gathered (e.g., training) are not part of the taxable base of the information service. If one fee is paid for

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109 Ibid

the information, as long as more than five percent of the total charge is taxable as information services, all the charge is taxed<sup>111</sup>. This rule can be avoided by breaking out the taxable and non-taxable portions of the service at the time of the transaction. For practical reasons, sellers may be unwilling or unable to do this. In Alabama, amounts paid to rent equipment for receiving data are taxable, but electronically transmitted information is not<sup>112</sup>. If the rental charges for such equipment were not billed separately, the entire amount (including the information services) would be subject to sales tax. Thus, bundled services may sometimes present a sales tax problem for businesses providing such services.

One effective means of taxing on-line content is to impose the sales tax on the furnishing of the information itself. This approach avoids the difficult issues of whether the transmission of content is tangible or intangible property, but it creates other problems. For example, some states impose a sales tax on 'computer services' whereas others impose it on 'information services'. In the former states, it is unclear if someone who downloads information on-line has also bought a taxable computer service. Similarly, it is equally unclear whether someone who purchases software on-line has purchased a taxable information service. The simplest way to avoid such definitional problems with the confusion and litigation sure to ensue is to adopt a broad definition of 'services' that are subject to sales tax, which includes telecommunications services, information services, data processing services, and other similar on-line services<sup>113</sup>. Even if the definition of taxable services were broad, however, it would not eliminate uncertainties and avoid disputes. Thus, Texas treats charges for providing educational classes and testing over the Internet as non-taxable, but separate charges by the Internet service provider for maintaining the web page and for processing student information are treated as taxable data processing services<sup>114</sup>. There appears to be no consistent principle for taxpayers.

### 6.2.3 SITUUS OF THE SALE

The question of where a taxable sale of electronic products or services occurs is difficult because the transactions frequently have meaningful contacts with more than one jurisdiction. For example, an information provider in State 'A' employing a server in State 'B' can sell access to its database through an ISP or OSP in State C to a customer in State D who is billed by a financial intermediary in State E. Which state can, does, and should tax the sale? (Hellerstein, 1997a) Hence, the third issue whether a taxable sale has taken place, is the situs of the sale. In most cases, sales have as their situs the location of the customer, and the customer's state is then free to impose a tax on the sale. When e-commerce is involved, the situs of the sale becomes more difficult to pinpoint, because the transactions are often multi-state in nature. The service provider may be in one state, the customer in another, and the computer used in the transaction in still another. Therefore, multiple states may assert sales tax jurisdiction over one transaction. While the rule for sourcing product sales seems simple enough, it is

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110 The Stock Market Photo Agency, Inc., Adv Op Comm T&F November 12, 1999, TSB -A-99(48)S

111 Supra Note 108

112 Supra Note 108

113 Supra Note 108 at Part II, 14 State Tax Notes at p 1372

114 Ibid

not. For instance, where goods are shipped from one state to another the delivery-state rules says that the sale is taxable in the state to which the goods are shipped. However, some states have determined that, based on the terms of the sale, the sale is taxable in the state from which the goods are shipped. In these cases, the state from which the goods are shipped, and the state to which the goods are delivered may both attempt to tax the sale?

Let us consider that 'ABC.com' is an online seller of clothing, with operations only in Tennessee. For customers outside Tennessee, 'ABC.com' does not collect sales or use tax. 'ABC.com' deposits goods in the mail for delivery to its customers. The statement on its order form says 'ABC.com' takes no responsibility for loss or damage to goods once placed in the mail. Tennessee has ruled, in a case with facts similar to this, that these terms of sale cause title to the goods to pass in Tennessee, when the taxpayer deposits the goods in the mail. This makes the sale taxable in Tennessee, though delivery, use, and consumption take place in another state. While Tennessee insists on taxing the sale, the delivery state may determine that the sale is subject to its own use tax, thus resulting in double tax unless a sales tax credit is available<sup>115</sup>. Like Tennessee, other states have their own rules for determining whether a product is taxable in the state. California, for instance, would not consider a sale taxable in the state even if it is delivered to the state, so long as the product is present in the state for only a short period of time, and substantial use of the product takes place elsewhere. Problems can also arise when a single product is used in multiple states. For instance, a multistate organization may purchase software and install it on a server in one state, with the intention of enabling business locations in other states to simultaneously access the software. The question is, in which state should sales or use tax be collected, and in which states should use tax be self-assessed.

Further sales of services especially online services used in multiple locations, presents real problems for both sellers and buyers and there are not enough rules to tell what state should tax a multi-state sale of online services. A major problem is the potential for confusion between the location where an online service is billed and where it is used. For instance, buyers may use services in different locations, accessing services from different computers. Alternatively, one buyer may purchase a service, but allow someone at a different location to use the service. Hardesty (2001) believes that this mismatch of the use and billing locations for non-business consumers is not likely to be a problem, since most use by an individual consumer is likely to take place at the consumer's billing address. More serious is online access to a service or digital product by multi-state businesses. For instance, it is likely that an online service will be billed to one location, but be used in other locations – possibly in states other than the state to which the service is billed. A mismatch in this case can cause serious problems for both the buyer and the seller, and even for the states. The seller may collect too little or too much tax, while the buyer may be subject to double taxation.

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<sup>115</sup> Tenn. Dept. of Revenue Ltr. Rules 00-29, 26 TAM pp 11-46 (Sep 1, 2000) as Cited in Hardesty (2001)

One possible approach to taxing e-commerce is to treat the state in which the predominant use of the service occurs as the state of situs. Services sold to locations outside the state would not be subject to sales tax. By analogy, most states treat the place where a telephone call originates or is received by the customer (and charged to the customer's address) as the situs of the call. A minority of states treat the location of the provider, not the customer, as the situs of the telephone call.

In some cases, apportionment of sales tax may be appropriate if consumers use the services in multiple states. The difficulty with apportionment is that the sales tax (unlike the income tax) is concerned with one transaction, a taxable sale at retail. Apportioning income among states at year-end is common for multistate businesses, but apportioning sales tax is unusual for a tax that is determined by the transaction itself. Although making the apportionment calculation is possible, it is difficult and counterintuitive. Moreover, states may be able to impose a sales tax on the entire transaction even if only a part of the service occurred in state. With respect to telecommunications services, a state in which an interstate call originates or terminates may tax the customer's purchase of that call as long as the call is charged to a service address or paid by someone within the state that seeks to impose the sales tax. However, it may not be difficult to determine the location of the buyer who uses a credit card to purchase a service or digital product. This is because almost all sellers demand complete address information from buyers to help combat credit card fraud. Identification of the location of buyers will become difficult if use of anonymous digital cash becomes widespread. Sellers are unlikely to need any information about buyers that make purchases using anonymous digital cash, and buyers will not willingly provide that information. Without even a billing address, online sellers will have no certain way to determine in what state a sale takes place.

The obvious solution is to have Congress enact a law authorizing state imposition of use tax collection obligations on out-of-state vendors selling to in-state customers over the Internet or on-line. This is not very likely to happen. However, it is worth discussing how a state sales tax that is economically neutral and relatively easy to comply with would be structured and indicates how extant sales taxes deviate from that system and the effects of those deviations. E-commerce can play as a catalyst for long-overdue action by state and local governments applicable to sales by other types of remote (out-of-state) vendors. In chapter-10, I shall revisit some these issues discussed here with some alternative answers. The avoidance of double taxation should be the first and foremost among the general principles governing consumption taxation, because the prospect of double taxation would do more to inhibit the development of electronic commerce than any other tax factor. Non-discrimination, neutrality, and the avoidance of excessive compliance obligations should be recognized as guiding principles for indirect taxation. In particular, e-commerce, regardless of whether the method of delivery is on-line or off-line, should not be subject to higher (or lower) tax rates or subject to greater compliance burdens than conventional commerce. Additionally, e-commerce imports should not be taxed at higher rates than domestic e-commerce. The guiding principles should include simplicity, encompassing the concepts of uniform classifications, clarity and consistency of rules, and minimization of compliance burdens and costs and protection of tax-base.

# Chapter – 7

## **E-COMMERCE: LOSS OF REVENUE AND EROSION OF TAX BASE**

### **INTRODUCTION**

The most fundamental threat to the international tax system posed by e-commerce is the erosion of worldwide tax base<sup>1</sup>, damaging the basic economic balance, economic efficiency, and competitive fairness among vendors (Bruce and Fox 2001). E-commerce provides threats similar to those posed in the 1980's with the rise of the 'big box' stores, their goal was not so much to feed off and feed into indigenous community-based businesses but rather to crush them and be the only retail destination in town.

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<sup>1</sup> Discussion report of the German Tax Office Electronic Commerce Project, Tax and the Internet. (August 1997).

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In contrast, independent merchants have traditionally done more than selling goods to local shoppers. They have supported the local economies through the buying of supplies from other local stores; employed the services of local lawyers, architects, accountants, and plumbers; banked at local banks and employed local builders and craftsmen (Jones and Basu, 2002). Such 'big box', stores are modern day colonialists exploiting local markets by taking resources out of the community without returning anything in kind (Ross, 1999). E-commerce and Internet businesses took the colonialism economic model of chain stores one-step further. Whereas chain stores collected sales tax, pay property taxes, and hire local workers, Internet-only businesses evade most of these activities, which are critical to the survival of communities and local economies. These concerns were however countered by those who argue that tax revenues overall would increase as productivity enhancements stimulated by the Internet and e-commerce will expand the economy and raise all States' tax revenues. A case had been made that new electronic technologies would allow output quality to rise and production costs to fall (Johnston, 1999). This is certainly true to a degree, however, it may also be argued that non-neutral tax treatment of e-commerce transactions would reduce rather than expand the economy. Hence as Goolsbee and Zittrain (1999) argued that '*any tax exemption should be short lived*'.

### 7.1 EROSION OF THE TAX BASE

The tax reforms implemented over the past several years were, at least in part, a response to the need to enhance economic performance. But they can also be understood as a response to the perception that tax bases were being eroded due to high tax rates, increased avoidance and evasion, and the migration of taxable income to low-tax jurisdictions (OECD, Outlook, 1998). Tax-base erosion could take the form of legal avoidance or illegal evasion. Examples of avoidance are numerous: taxes could be avoided or evaded by shifting the taxable location of the activity to other jurisdictions. One type of tax-base erosion that has attracted considerable attention and concern is the geographical mobility of tax bases. E-Commerce has increased the scope for tax avoidance and evasion through the choice of location of economic activity. Business functions could be moved to low-tax jurisdictions and bank accounts and other financial assets could be held offshore. There are numerous examples of avoidance reducing tax revenues and, in some cases; tax rates have had to be reduced in order to stem the revenue losses. Empirical research also supports the view that taxation influences international investment flows, although some studies find little effect (Leibfritz, 1997).

The effect of geographical mobility on tax bases raises a number of concerns. The first is the extent to which the overall revenue-raising power of governments has been constrained. However, there is reason to believe that the pressures stemming from geographical mobility of tax bases would increase in the years ahead. As in this case, improvements in e-commerce would make the base for consumption taxes, more geographically mobile and harder to trace. In general, the location of economic activity depends on many factors, of which taxation is one. An equilibrium taking account of these factors is established that, to date, has both constrained tax rates in many cases while still allowing substantial

variability of tax rates across jurisdictions. However, this equilibrium is likely to shift as, inter alia, institutions and technologies develop. The challenge for tax policy would be to respond to these developments in order to fund needed government expenditures with a tax system that has minimal economic distortions. In view of trend toward globalisation and the threat posed by the geographical mobility of tax bases, a significant part of the response would necessarily involve greater international co-operation. It is increasingly difficult for individual countries to manage their tax bases in the face of these forces and, in particular, some tax practices have led to harmful and destructive cross-border 'tax competition' (OECD, Outlook, 1998).

A narrow definition of a tax base creates problems for desired neutral tax treatment between traditional economic activity and activity involving digital goods. Consider the sale of a tangible good such as a print book; if a consumer purchases a particular copy of a book then nobody else has the right to buy that particular book. In contrast, the sale of a digital book will not constrain the potential consumption of this product due to the ability to reproduce the digital book at much lesser cost. The digital book is hence non-rival in consumption<sup>2</sup>. What are the tax implications that result from the fact that digital goods are non-rival goods? From a tax theory perspective, consumption is normally equated with using up economic resources. However, non-rival resources do not actually get used up in any real sense if they could be replaced without cost. Still, this does not appear to pose any problems outside of theory because consumption tax systems generally only tax the purchase of goods and services in the market rather than actual consumption<sup>3</sup>. However, the way companies would price non-rival digital goods may present new tax policy challenges. Information economists assert that the non-rival nature of digital or information goods changes, at least to a certain extent, the way that companies should price their goods and services<sup>4</sup>. The potential near costless and infinite reproduction and supply of a digital good abolishes the supply side resource constraints that help to determine an appropriate equilibrium price. As a result, it is thought that, they would appear to engage in selective pricing of their digital goods. A digital product could be priced higher for commercial actors and lower for individual consumers. What happens when the price of a digital good drops to zero? Under economic theory, companies would set the price of most goods at the marginal cost of production. Assuming the company cannot differentiate its product (e.g., bundle the information good with a value-adding service) then, it had been noted, that price competition should eventually lead to a price of zero for many information goods<sup>5</sup>. However, companies would be able to generate a return on the digital goods through indirect means such as advertising. In these circumstances, the jurisdiction of consumption misses consumption tax revenues (Cockfield, 2002) (which are applied as a percentage of the sale price) because of its inability to tax

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<sup>2</sup> For discussion on rival versus non-rival goods, see Richard Musgrave, *Fiscal Functions of the Public Sector*, in 'Defining The Role Of Government: Economic Perspectives On The State' 1, 3 (Queen's University School of Policy Studies 1994) (noting that private goods are normally rival in consumption unlike public goods which are non-rival in consumption).

<sup>3</sup> Warren, Alvin (1980) at pp 1081-1084

<sup>4</sup> Hal R. Varian (1998) *Markets For Information Goods* as cited in Cockfield (2002)

<sup>5</sup> Hal Varian (1996) *Differential Pricing and Efficiency*, First Monday online journal available at <http://www.firstmonday.dk/issues/issue2/different/>

and would further cause erosion of tax base.

**7.2 EROSION OF THE TAX BASE - REDUCTION IN TOTAL TAX INCOME**

Much has been said about the importance of e-commerce to state tax revenues, with particular attention to effects that interstate sales have on the ability of states to impose and collect consumption taxes. Estimates of the state and local government revenue losses for states, at least in general discussions, cover the spectrum from the expectation that state tax bases would be devastated to the contention that tax revenues would actually be increased by an economy that is invigorated by the internet. The differences depend on the perspective taken on issues such as the role that taxes play in allowing the development of e-commerce, the time analysed, and forecasts of how rapidly e-commerce will expand. Nearly everyone agrees that the revenue losses to date have been relatively limited because e-commerce is still in its infancy. The important question from a policy perspective, then, is how the losses would grow in the near and longer term, since it is future rather than current losses that would be affected by policy decisions and which should be a factor in structuring policy. As with most issues, the probable reality of the revenue implications lies between the purported extremes.

If consumer transactions are taxed differently because of how commodities are obtained, efficiency losses are probable. Exempting business inputs purchased by e-commerce, while taxing many business inputs obtained in other forms, potentially at higher rates, could increase those efficiency losses. Goolsbee (1999) from research in the United States on the impact of taxation on e-commerce and consumer on-line purchasing patterns, concludes that consumers living in high sales tax areas are significantly more likely to buy on-line than those living in low sales tax areas. Hence, differentiated e-commerce taxation rules among countries could have a significant impact on consumers' purchasing behaviour, shifting from domestic to foreign suppliers<sup>6</sup>. Mazerov and Lav (1998) concluded that a moratorium on taxation of Internet sales would therefore benefit the affluent consumer able to shop around on the Internet at the expense of those with low and moderate incomes, with the resulting loss of tax revenue. The impact of such tax revenue losses would vary according to a countries' reliance on consumption tax as proportion of their total tax revenue. Major differences exist between the EU and the United States; the EU countries derive a large proportion of government tax revenue from consumption taxes on domestic goods and services (mainly VAT)<sup>7</sup>. In addition, VAT extra charges contribute 45% to the EU Community budget (in addition to customs duties and GNP contributions)<sup>8</sup>. The US government, on the other hand, derives most of its tax revenues from personal and corporate

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<sup>6</sup> Although there are also barriers that could prevent this shift, such as other regulatory obstacles (besides taxation), delivery problems, or cultural and linguistic barriers. To circumvent these, some United States suppliers have started to buy local competitors in Europe (The Economist, 2000).

<sup>7</sup> 29%

<sup>8</sup> The 45% contribution in 1997 was reduced to 35% in 1999 (projection) (European Commission, 1998).

income tax and social security contributions.<sup>9</sup> The US is currently both a net exporter and the main exporter of e-commerce worldwide. Hence, it has a great interest in encouraging business (including e-commerce business) to locate in the US and pay direct taxes to US tax authorities. The EU however has considerable concerns over the increasing import of digital content and services from outside the EU, which would be exempted from VAT payments in the EU. It is not surprising, therefore, that the issue of consumption taxes has received most attention in the OECD and the EU. In particular, the EU feels very strongly about maintaining VAT duties and has modified tax rules in a way that will ensure a continuation of VAT contributions, rather than lowering or eliminating them.

Meijers (1998) tried to quantify the magnitude of the effects of e-commerce on tax income. The analysis was carried out for the Netherlands, using a Dutch macro-economic model. Looking at the country of origin for on-line goods and services, he found that for the Netherlands, the *imports from the US* were much more important than the imports from other European countries. From survey data, it came out that about one-third of the goods and services purchased through the Internet by Dutch inhabitants were sold by US firms. Based on these assumptions, the simulation experiments carried out on imported goods and services, which were purchased through the Internet and other on-line services, the on-line imports, that were taxed in a normal way. This implied that all goods were traced by the customs officers and that either there were no imported immaterial goods and services or that the buyers or sellers pay the indirect taxes to the tax authorities. As discussed before, on-line services like computer software, video-on-demand, music-on-demand, tickets can be traded through the Internet without being observed by the tax authorities<sup>10</sup>. Moreover, it is likely that the custom officers would not always be able trace physical goods and consumers are often not aware of the fact that they should pay VAT on imported goods and services from outside the EU. As it stands this implied that the indirect taxes on these imports from the US were not likely to be paid.

In order to investigate the effects of this tax evasion (or tax avoidance), Meijers (1998) used both scenarios in which it was assumed that the VAT of 17.5%, the current Dutch VAT percentage, was not levied on (about) 50% of all on-line imports. This would have two effects: *first*, the import prices were reduced because of which the imports would increase. This would lower GDP and employment. *Second*, the government tax income would be reduced. In the first scenario, where there were very little on-line imports, the effects were not that drastic: in 2000 the deficit was increased by fl. 10 million (ECU 4.5 million), as compared to the first simulation run, whereas this figure increases to fl. 30 million in 2020 (ECU 13.5 million). However, for the high scenario, things become more serious. On-line shopping as a percentage of total private expenditure was still low in 2000 (about 0.8%) but would

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<sup>9</sup> Within the United States, individual states and local governments have autonomy over determining and collecting state and local sales tax, often their biggest source of revenue. Sales taxes differ substantially among states, ranging from 0 to 7%. United States-based on-line suppliers selling to out-of-state (including foreign) customers do currently not have to charge local sales tax. States are therefore becoming increasingly worried about how to secure their sales tax revenues in the light of e-commerce.

<sup>10</sup> For further discussion Chapter-8 EU Directive VAT on Digital sales

increase rapidly to almost 3% in 2005 and would reach 5.5% in 2020. So, whereas the effect was expected to be minor in 2000, it could become more important from 2005 and onwards. Indeed, the increase of the government deficit was only fl 80 million (ECU 36 million) in 2000 due to tax avoidance (in nominal terms). The increase of the deficit would be about fl 300 million in 2005 (ECU 135 million) whereas it would be more than fl. 1.4 billion in 2020 (ECU 0.63 billion). A reduction of the tax income by ECU 0.63 billion in 2020 due to the tax evasion, compared to the nominal value of the GDP in 1997 relative to the GDP in 2020, equal to about ECU 0.25 billion in 1997. This was about equal to the total budget of the Dutch Ministry of Finance in 1997 (excluding the rents on government debts), about equal to the total budget of the Ministry of Agriculture, one-third of the total budget of the Ministry of Defence and one-seventh of the budget of the Ministry of Education, the largest Dutch Ministry in terms of budgets (Meijers, 1998). However, the reliability of the data on which this assumption was based for giving a decisive answer to the question what the effects of e-commerce on tax erosion could be questioned but then it was a positive step in the right direction emphasising the magnitude of e-commerce and its effects on tax income.

In US the State, sales tax bases had been declining relative to state personal income for many years. For the average sales-taxing state, the tax base equalled 51.4% of the state's personal income in 1979, but had fallen to 42.8% in 1998 (Bruce and Fox, 2000). The most important foremost factor responsible for erosion of tax base was the shift in consumption patterns towards greater consumption of services and less consumption of goods. Services are much less broadly taxed than goods, meaning the base shrinks relative to the economy as services become more prominent. There is evidence in shift of consumption patterns towards greater consumption of services and less consumption of goods. Services are much less broadly taxed than goods, meaning the base shrinks relative to the economy as services become more prominent (Fig 7.1)(Bruce and Fox, 2000).

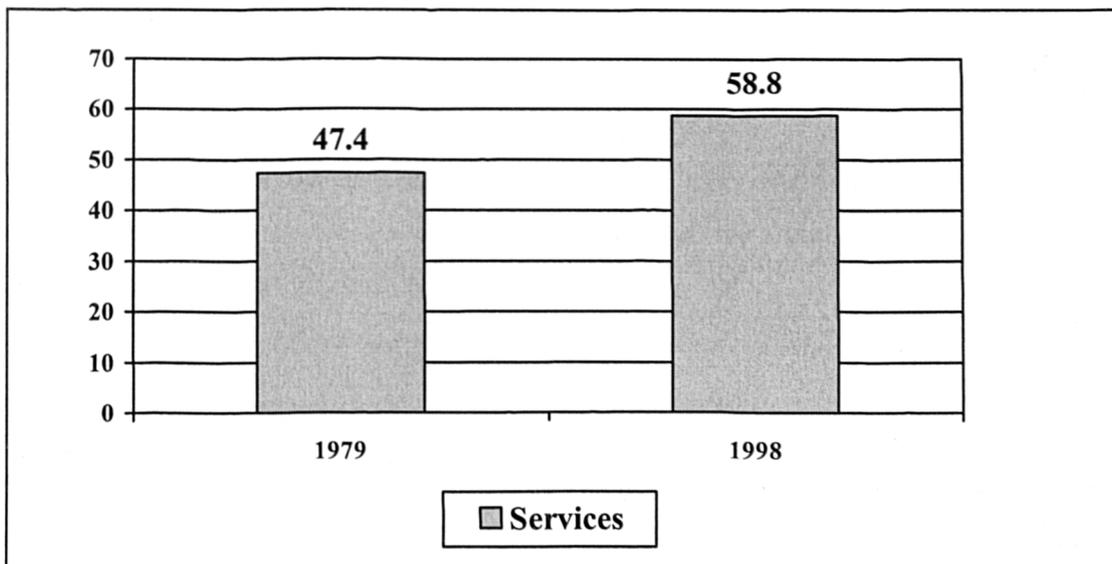


Figure 7.1: Spending on Services (US)

The revenue losses from e-commerce generally arise because e-commerce significantly expanded the potential for remote sales causing a shift from collecting sales taxes at the point of sale to collecting use

taxes for goods used, consumed, or stored in the state. Compliance rates are much better for sales taxes than for use taxes. The revenue losses described here are generally the result of tax evasion, not tax avoidance, since the use tax is due even if the sales tax cannot be collected.

Proposals to make the Internet a tax free zone could promise an end to sales and use tax revenue, going well beyond the problems of the current physical presence rule. The devastation to the sales and use tax results because virtually all business activity involves, at some stage in the purchase process, acquisition through e-commerce, every store to-customer transaction would have been an Internet transaction at some stage of the flow of commerce and hence not subject to taxation (Weiner, 1999). With strictest definition, the sales tax base falls to zero-not even the purchase of a motor vehicle would not be taxable-and states and localities would have a major fiscal problem. At a minimum, the law would require massive interpretation to determine what is and what is not enough connection with the Internet to make it tax free. Neither outcome would seem to be acceptable under normal ideas of sound tax policy.

Bruce and Fox (2001) study based on e-commerce sales drawn from Forrester Research Inc.'s annual forecasts for the years 2001 through 2011 forecasts showed that the incremental revenue loss from e-commerce sales is estimated to be 41% more than previous report of 2000 had indicated due to higher business-to-business (B2B) transactions forecast by Forrester. In 2001, e-commerce caused a total state and local government revenue loss of \$13.3 billion. By 2006, this loss would be more than triple to \$45.2 billion and in 2011; the loss would be \$54.8 billion. The total e-commerce loss is the sales tax loss on all sales over the Internet. Part of the loss would have occurred anyway even without e-commerce on sales, for example, which might have otherwise been made by purchasers using the telephone and catalogues. The new e-commerce loss is from sales made through the Internet both on goods that would have otherwise been purchased from the over-the-counter method and projected new goods that will be purchased over the Internet. In 2001, the new e-commerce loss was \$7 billion, in 2006, it grows to \$24.2 billion and in 2011, and it is \$29.2 billion. Measuring the states' e-commerce revenue losses against their total state tax revenues also shows significant impact. In 2011, states would lose anywhere from 2.6% to 9.92% of their total state tax collections to total e-commerce losses. A final measurement of the impact of e-commerce losses is the needed increase in the sales tax rate to replace the lost revenue. In 2011, rates would have to rise by between 0.83 and 1.72 percentage points to replace the total e-commerce losses. The dominant role that B2B is expected to play in e-commerce sales means that the ability to collect revenues on B2B transactions is very important to the revenue loss for state and local governments. Indeed, B2B transactions represented 92.6% of all e-commerce activity in 2001 according to the Forrester forecast, a share that would expand to 95.0% by 2011 (Fig 7.2) (Bruce and Fox 2001).

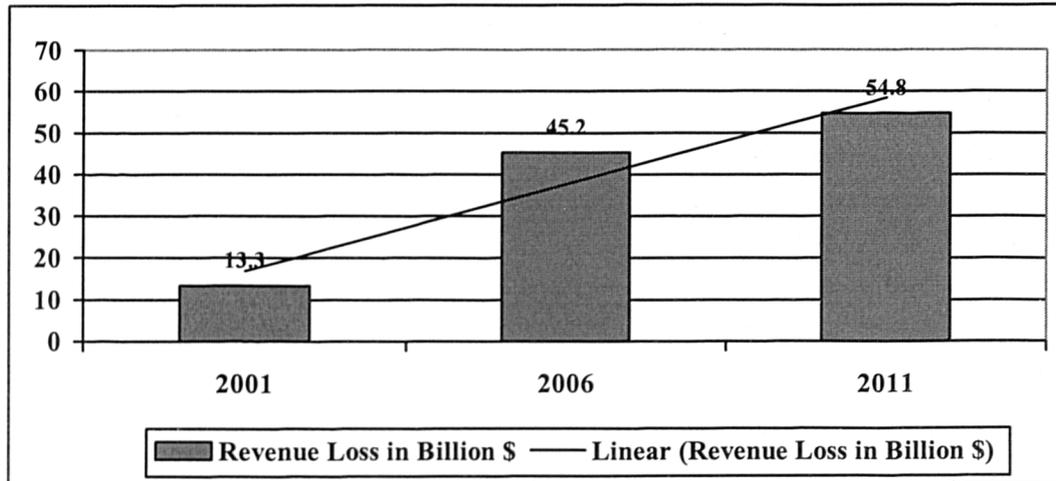


Figure 7.2: Estimated Revenue loss: Based on the Study by Prof. Bruce and Prof. Fox

The sales tax base erosion that was stimulated by e-commerce is part of a downward trend in the tax base that has been underway for many years. However, e-commerce has accelerated the trend that otherwise appeared to have been slowing in the middle 1990s. The revenue loss estimates provided here, totalling more than \$16 billion in 2001 and nearly \$45 billion in 2006, suggest that the combination of the trend decline and e-commerce would significantly alter state tax structures during the next several years. The overall revenue-raising power of governments has been constrained. Theory offers a wide range of possibilities, with the most pessimistic being that tax rates and tax revenues would be forced progressively downwards, even to the point where it becomes impossible to collect any revenues at all. The decline in the tax base in e-commerce would be caused by the loss of consumption-based taxes resulting from the difficulty in taxing purchases from outside the jurisdiction. This would be aggravated by the loss of tax revenue from workers displaced by new information technologies. To this 'double whammy' would be added the increase in tax avoidance (as explained in previous section) made easier by the lack of paper trails on the Internet. Countries will be encouraged to move more towards indirect taxation, which will affect more on poorer families. Between countries, there will be considerable differential impacts due to the countries ability to both shift to an indirect taxation system and to participate in the growth potential of e-commerce. It is my contention developing countries would have greater difficulty on both these counts.

### 7.3 EROSION OF THE TAX BASE: THE MOVE FROM FAIR TAXATION

Tax regimes should be fair in both its horizontal and vertical dimensions. The definition of a 'fair' tax is, of course, at least partly a matter of opinion. However, as discussed in chapter-4 some progress has been made using concepts such as horizontal equity and vertical equity. A tax system violates horizontal equity if taxpayers in similar situations pay markedly different amounts of tax. Vertical equity commonly is framed as ensuring a fair relationship between the tax burdens (usually defined as a fraction of income paid in tax) on households with different levels of income.

In order to recover from the revenue loss State and local governments would be confronted with limited choices: they must either cut expenditures, increase existing sales tax or VAT rates, or shift to another tax source, such as the property or income tax. Each choice has important implications. The effects of the first option, shrinking government, depend on the choices that are made. For example, reducing education and infrastructure spending could lower the economy's growth potential. If the size of government is not cut, the issue comes down to the way in which state and local governments are to finance themselves. With these decisions goes the full range of implications regarding taxation, including equity, administration and compliance, and behavioural incentives. From a public policy perspective the issue is whether state and local governments are better financed with the triad of sales, property, and income taxes, or whether the sales tax base should be allowed to continue shrinking and the focus increasingly shifted toward other broad-based taxes. (Bruce and Fox, 2001).

Replacement of the lost local sales tax revenues with higher property taxes and the lost state revenues with higher income taxes would change the overall revenue mix. Bruce and Fox (2000) estimated on the baseline scenario, the sales tax would fall from 25.1% to 22.6 % of revenues between 1996 and 2003 if there were no rate hikes. In order to recover this loss in a revenue-neutral fashion, the personal income tax would have to rise from 21.2 to 23.2% of total taxes and the property tax would have to rise from 30.2% to 30.6%. To replace only the new e-commerce losses in 2006 (based on 2001 estimation), sales tax rates will have to rise by between 0.44 and 0.91 percentage points. People who make purchases through the Internet are, on average, more affluent. Internet purchases generally require a personal computer with a modem, a connection to the Internet through a service provider, and a credit card with which to pay for the purchase. Income and education are key elements in the ownership of personal computers. Media Metrix (1998) reports that Internet users own the most powerful and expensive computers. Moreover, the Internet is increasingly being used to make purchases of luxury items. The Internet is especially well suited for consumers who want to customise their purchases of golf clubs and bicycles from hundreds of possible specifications<sup>11</sup>. On the other hand, lower-income households lack the equipment to access the Internet, the training to use the equipment, and/or the financial stability and credit rating required for maintaining a credit card.

As Internet sales become a more significant share of consumption, states would likely to see taxable sales and consumption tax revenues diminish. The option would be to raise their consumption tax rates to maintain revenues given they would be unable to tax Internet sales. However, indirect taxes are regressive; they absorb a larger share of the incomes of lower-income households. Increase in sales tax rate could set off a vicious cycle leading to ever sales taxes that are more regressive. As tax rates rose, higher-income households and businesses with Internet access would have an ever greater incentive to make their purchases on-line to avoid taxes, while lower-income households without access to on-line services would remain liable for the taxes. Sales tax liability would be increasingly concentrated among the lowest-income segments of the population. As already seen in addition to this states were forced to

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<sup>11</sup> 'Build It Yourself - <http://www.internetworld.com/print/current/ecomm/19980302-build.html>.

reduced state funding programmes to compensate for diminished revenues, which causes disproportionate cut of benefits for lower-income families and individuals. The result is unfairness in both the horizontal and vertical aspects of the tax regime. There is evidence of such patterns of shifting tax liability from the use of mail order, upper-income households tending to use such systems more than low to middle income households<sup>12</sup>. There is no compelling policy reason why the governments should favour the wealthy and well-financed corporations and their equally wealthy customers at the expense of other businesses and other consumers. Community-based businesses and the cities and towns they serve are now endangered by unfair and ill-conceived economic distortions due to the tax breaks e-commerce companies enjoy. I accept that governments should be encouraging the growth of e-commerce, but argue that issue of unfairness in the tax regimes be considered in the light of such growth.

### 7.4 REVENUE LOSS FOR DEVELOPING COUNTRIES

The digital divide shows that the rich and educated have the best access to computers and Internet (for more detail see Marsh<sup>13</sup>). More high-income consumers shop online than low-income consumers. This is intuitive because they have a higher willingness to pay the fixed cost to shop online and their time is worth more to them (which makes the conventional shopping less attractive). Therefore, if the online tax rate is lower than conventional tax rate, the average affluent person will pay relatively less of their income in consumption taxes than the average poor person. Given a sufficient decrease in the cost fixed cost of shopping online, the electronic region can 'enter' and attract a tax base if they set relatively low tax rates. As the fixed cost of shopping online continues to decrease, increase usage of the e-commerce as a way of shopping is expected to rise. Conventional regions would see both lower tax bases and tax rates which would lead to lower tax revenues and this would make the developing countries more vulnerable because of their greater dependence on tariffs and taxes as revenue sources for their national budgets. In order to raise the lost revenue situation ideally calls for the rich to be taxed more heavily than the poor, but the economic and political power of rich tax payers often allows them to prevent tax reforms that would increase their tax burdens. This practically explains why developing countries are more dependent on indirect taxes. In developing countries, tax policy is often the art of the possible rather than the pursuit of the optimal (Jones and Basu, 2002)

Tax exemption is at present a consistent policy justified to encourage the growth of e-commerce. Earlier discussion in chapter-2 clearly indicates that e-commerce has achieved unparalleled growth not only in the developed countries but also in a large number of developing countries. It would appear that the success of e-commerce would depend not on tax exemption but on Internet access, education levels,

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12 Statistics form Direct Marketing 1997

13 Electronic Commerce and Tax Competition: When Consumers Can Shop across Borders and On-Line, Working paper No.00-13, November 2000, Department to Economics University of Colorado.

the propensity to consume imported products traded on the Internet, domestic alternatives, and prices.

Hence, what would be the impacts on the tax incomes of developing countries? Most of the developing countries rely heavily on consumption taxes. Data from industrial and developing countries show that the ratio of income to consumption taxes in industrial countries has consistently remained more than double the ratio in developing countries, that is, compared with developing countries, industrial countries derive proportionally twice as much revenue from income tax than from consumption tax, (Tanzi and Zee, 2001). Developing countries are also importing countries, that is its citizens and companies tend to buy from foreign countries more than foreign countries buy from its citizens and companies in contrast developed countries consist of relatively wealthy, exporting nations. While the size of these export-import trade deficits vary from year to year and from country to country, such deficits nevertheless overwhelmingly exist for developing countries. Within the WTO, developing countries have raised concerns about possible tariff revenue implications resulting from a ban on customs duties on electronic transmissions. However, they lack resources to provide evidence, which could support their concern. Many of them are still struggling to keep up with the rapid developments in area of e-commerce recognising that e-commerce has two sides and has the potential for substantial beneficial effects on their economies (Jones and Basu, 2002). US account almost 20% of world exports of digitizable products followed by UK, Germany, Ireland, Japan, France, and Netherlands, with a combined account of 66.5% of total exports. Developed countries account for 88.5% of exports, while the developing countries' share is only 11.5% (Table 7.1). Among the developing countries, the main exporters of digitizable products are Singapore, Hong Kong, China, Mexico, Korea, India, Honduras, and Chile<sup>14</sup> (Teltscher, 2000).

<b>WORLD TRADE IN DIGITAL PRODUCT 1999</b>			
	<b>World</b>	<b>Developed country</b>	<b>Developing country</b>
<b>Total Imports, US\$ bill.</b>	48.2	40.5	7.7
<b>Total Exports, US\$ bill</b>	46.4	41.0	7.7
<b>% Share</b>	100	81.5	18.5

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<sup>14</sup> It may come as a surprise that India is not among the main developing country software exporters. This can be explained by the structure of the Indian software industry where software *services* account for 95 per cent of Indian exports whereas software *packages* (i.e. the products considered here) constitute only a small proportion of the Indian software industry output.

World DP imports			
% Share World DP exports	100	88.5	11.5
DP Imports, % Share	0.9	1.0	0.4
DP Exports, % Share	0.9	1.1	0.4

Table 7.1 World Trade in Digital Products, Source Teltcher (2000)

On the import side, the US has again the largest share (16% of all imports), followed by the UK, Canada. Main importers from the developing countries include Hong Kong, Mexico, Korea, China, Singapore, Brazil, South Africa, India, and Argentina. The developed countries' share in total imports of digitizable products is 81.5% (Table 1). Growth rates for both exports and imports of digitised products are significantly higher than growth rates of total merchandise trade. In particular, developing countries' imports have grown considerably throughout the decade, although they slowed down in 1997 and 1998 (Fig 7.3 and Fig 7.4). The question here is how significant is this revenue loss for the developing countries.

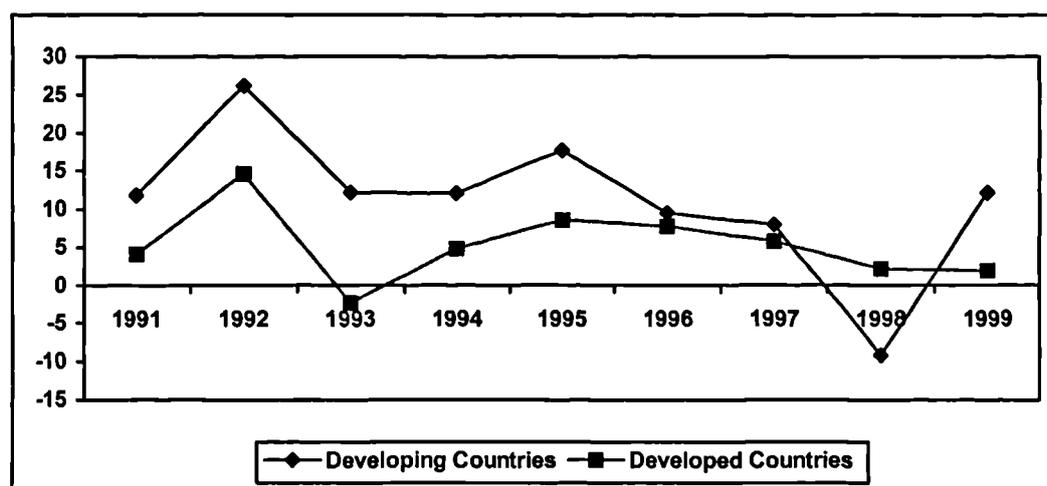


Figure 7.3: Annual Growth rate of Digital Imports

Source: COMTRADE; UNCTAD Handbook of International Trade and Development Statistics

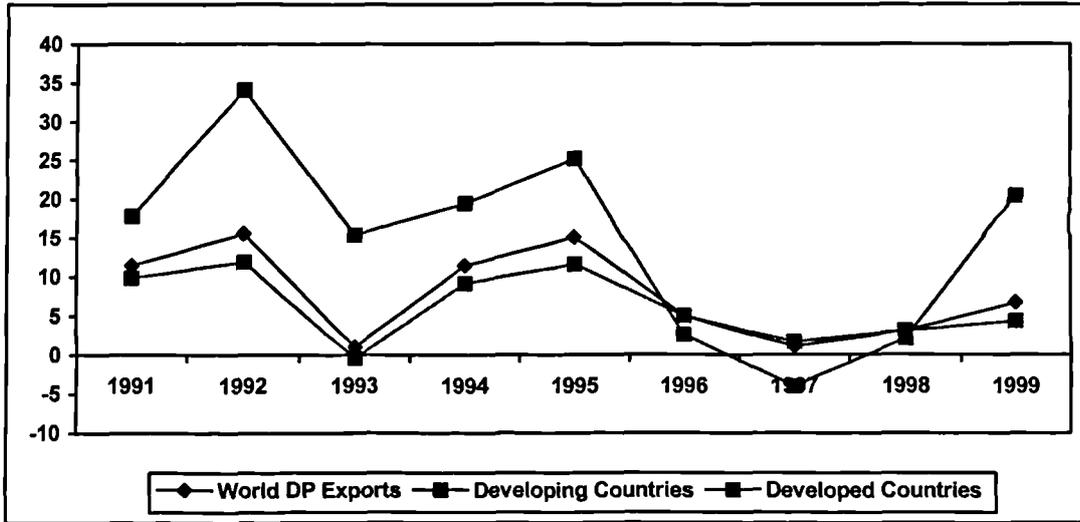


Figure 7.4 Annual Growth rate of DP exports, Source: COMTRADE

The tariff rates of the developing countries are higher than those of developed countries. Technological advancement affected diverse nature of products (Fig 7.5 and 7.6).

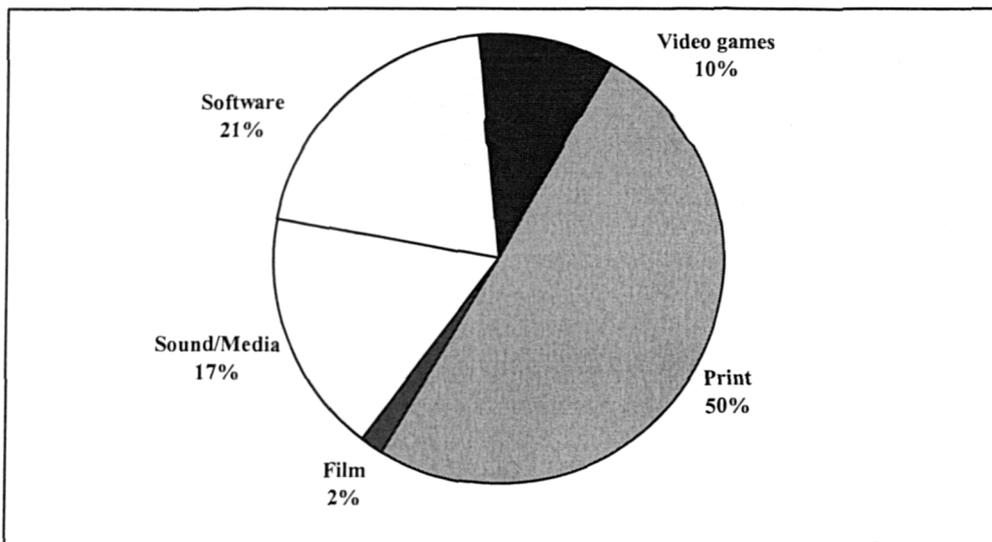


Figure 7.5 DP exports by Category, Source: COMTRADE. Data based on 85 reporting countries, Representing 85% of world trade for the year 1999

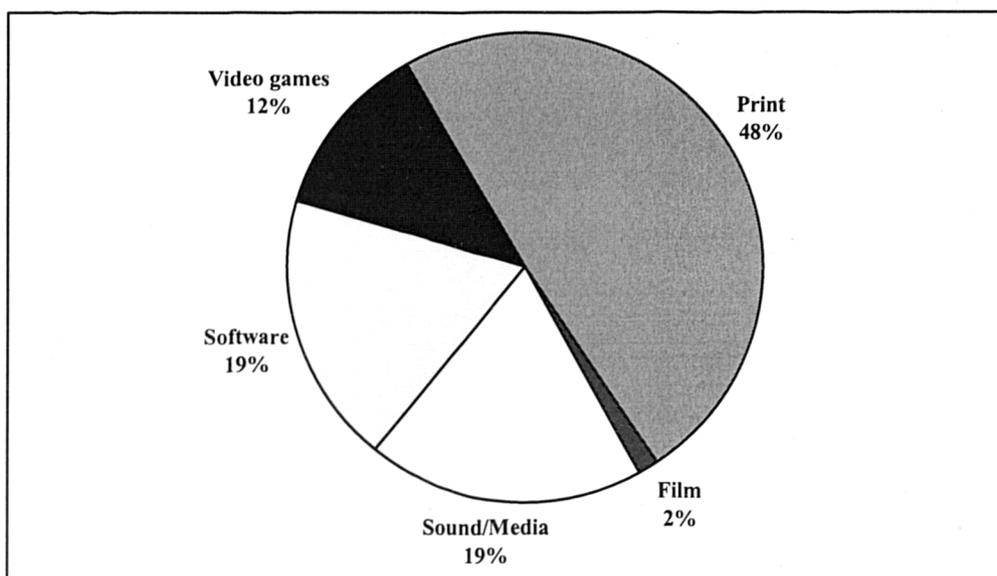


Figure 7.6 DP Imports by Category, Source: COMTRADE. Data based on 85 reporting countries, representing 85% of world trade for the year 1999

In order to calculate potential revenue losses resulting from a shift from physical to electronic delivery of goods, these trade flows have to be linked to tariff rates currently imposed on the various products<sup>15</sup>. Data show that significant differences exist among the products (Fig 7.7 and Fig 7.8). For example, while low tariffs (2-3 %) prevail on books and newspapers, high tariffs (up to 20%) are imposed on postcards, calendars, and commercial catalogues all of which comprise the 'printed matter' group. Higher tariffs also dominate most of the sound and media products as well as video games.

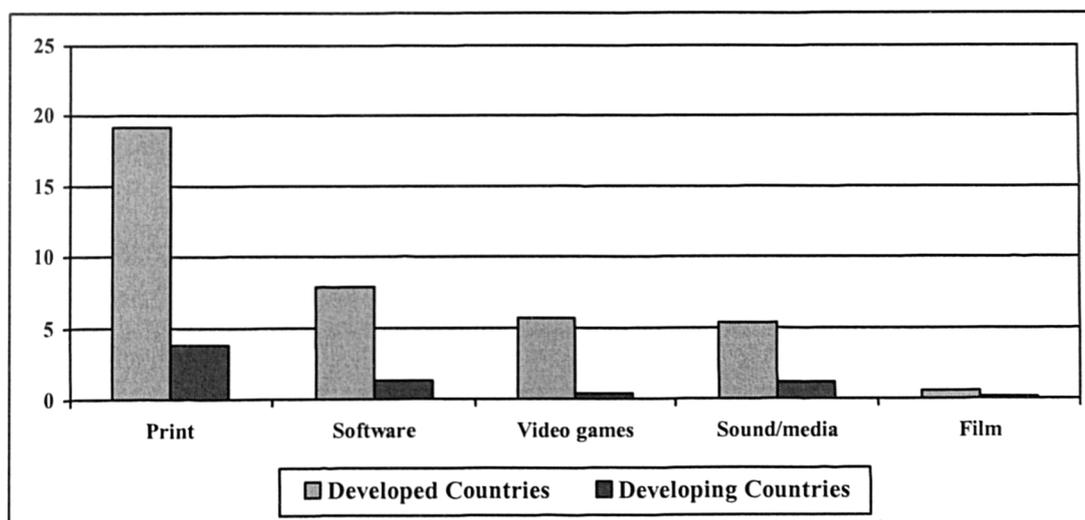


Figure 7.7 Digital Import by Commodity group

<sup>15</sup> This is useful for finding out which countries might be most affected by a ban on customs duties on these goods (in case of substitution of physical by electronic delivery), it doesn't offer much information on the tariff rates levied on different products. It also plays an important role considering that not all products are likely to be substituted immediately or in the near future, and some may always be distributed in physical or 'tangible' format.

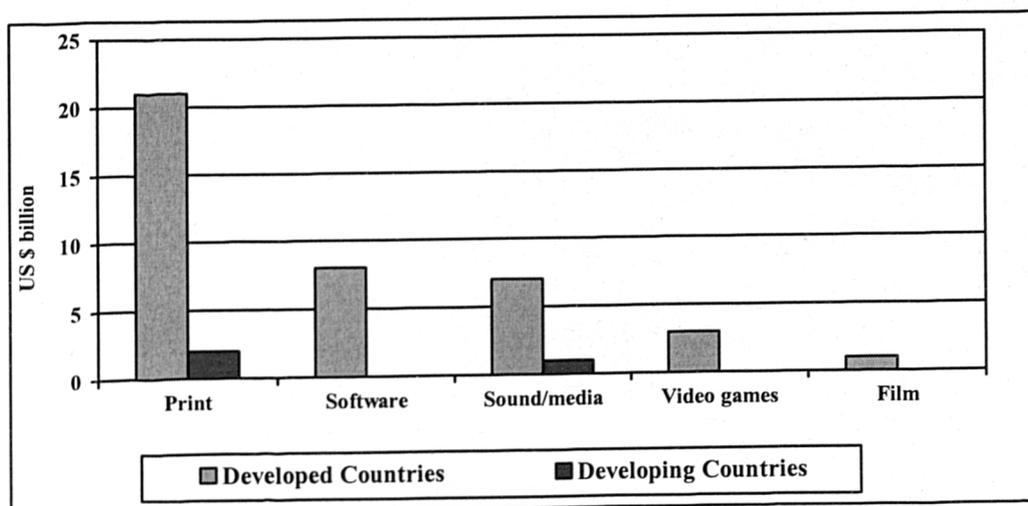


Figure 7.8 Digital Exports by commodity group

A disaggregating the average MFN<sup>16</sup> tariff by developed/developing country would show that developing countries on the average have higher tariffs on all product lines compared to developed countries (Fig 7.9).

16 Within the WTO, there are important political and regulatory implications associated with the electronic delivery of goods and services. Depending on the classification, the trade is subject to different multilateral rules: goods are subject to the GATT, the Agreement on Technical Barriers to Trade, the Agreement on Customs Valuations, or rules of origin; while services would be subject to the GATS Agreement. In general, the multilateral rules for services are still far less elaborate than the multilateral rules for trade in goods, providing countries with substantially more leeway for national policy discretion in the services trade. One important difference between the GATT and the GATS relates to general obligations. While the GATT's general obligations include most-favoured-nation treatment (MFN), national treatment, and a general prohibition of quantitative restrictions, the GATS include the national treatment principle only in negotiated specific commitments and specific services. MFN treatment requires WTO members to apply the same duties and charges they apply to any Member of the WTO, immediately and unconditionally to all other Members. For example, if a country negotiates and agrees upon an import tariff rate with one country, the same tariff rate must be applied to all other member countries.

GATT (1994), 'The Results of the Uruguay Round of Multilateral Trade Negotiations. The Legal Texts', Geneva.

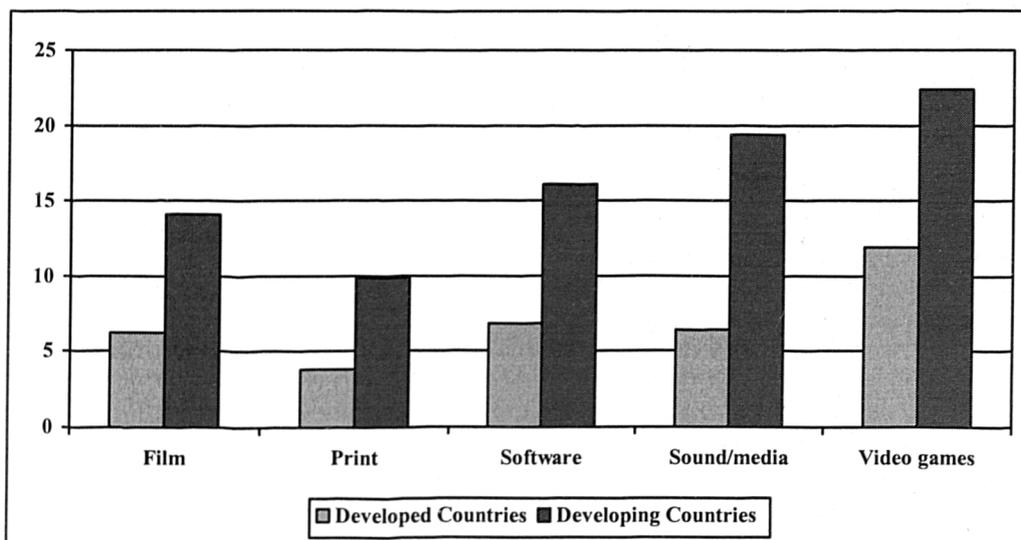


Figure 7.9 Applied MFN rates on DP imports per commodity group

What fiscal losses would occur should physical delivery of products be replaced by electronic delivery and no tariffs imposed on the latter? The majority of countries that are mostly affected by tariff revenue losses come from the developing world (Fig 7.10).

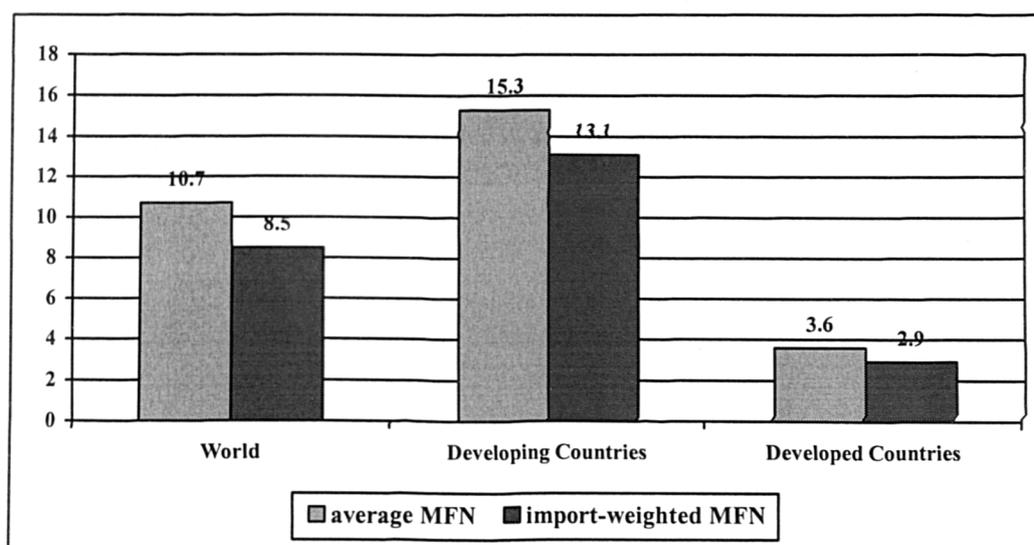


Figure 7.10 Applied MFN rates on DP imports, 1999

What is remarkable, however, is the magnitude: despite the developing countries' import share in digitizable products of only 18.5% (Table 1), their absolute tariff revenue (loss) is almost double that of the developed countries, amounting to 63% of world tariff revenue losses for these products (Fig 7.11 and Fig 7.12).

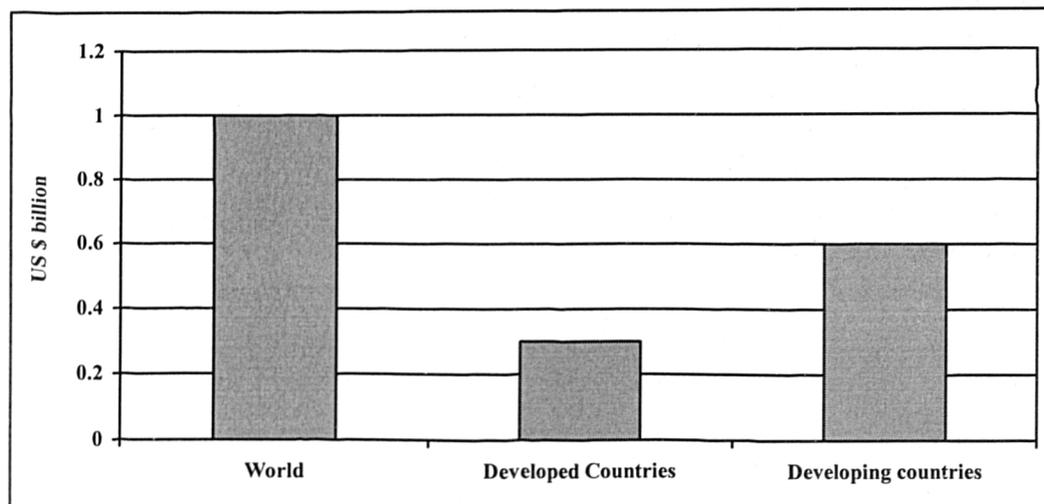


Figure 7.11 DP Tariff Revenues, 1999

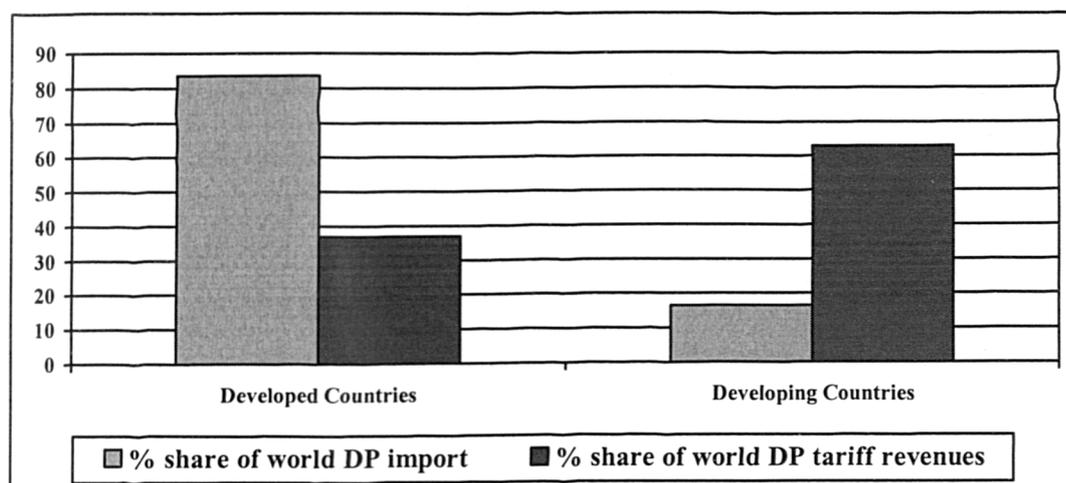


Figure 7.12 Digital Imports and Tariff Revenues, 1999

This clearly shows that, as far as potential fiscal losses are concerned, developing countries would be much more impacted by the proposed ban. The top ten countries affected by fiscal loss are the EU, India, Canada, Mexico, Brazil, China, Russia, Poland, Argentina, and Thailand (Teltscher, 2001). Schuknecht (1999) placed these losses in the context of total government revenues compared tariff revenues from digitizable products to total revenues and revenues from import duties (Fig 7.13).<sup>17</sup> The percentages are relatively low for all countries, tariff revenues from these products account for only 0.16 % of total government revenues and 1.7% of revenues from import duties. Nevertheless, some significant differences exist between countries, with shares ranging from 0 to 0.16% of total revenue and from 0 to 2.7% of revenues from import duties (Teltscher, 2000)<sup>18</sup>.

<sup>17</sup> Schuknecht, L. (1999)

<sup>18</sup> Furthermore, customs duties as a source of government revenue play a much more important role in a number of developing countries: while government revenues from import duties account for 2.6 per cent in developed countries, they account for 15.8 per cent in the developing countries.

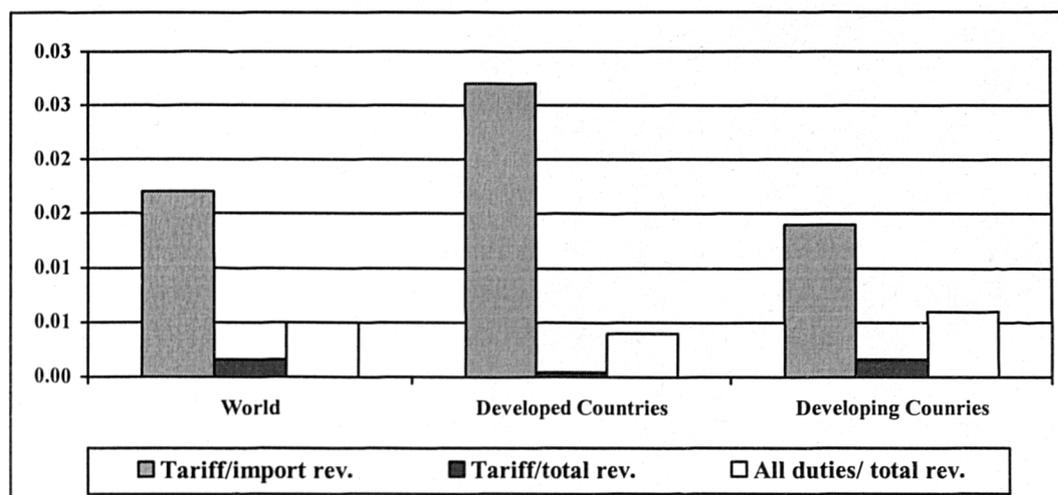


Figure 7.13 Shares of Digital Product import Revenues in Total Gov. Revenue (%)

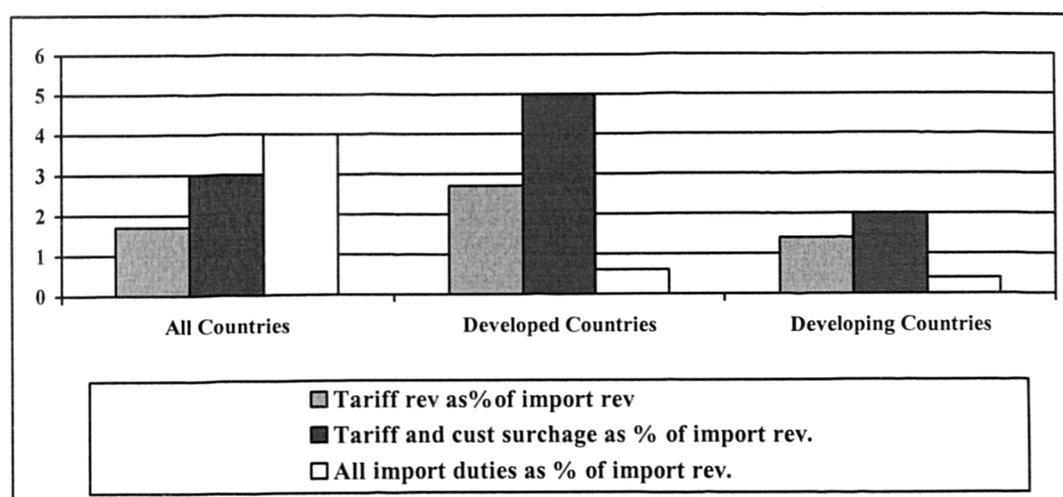
Apart from the applied tariffs, there are a number of additional duties and taxes levied on most imports by most countries. If imports of physical goods were replaced by electronic delivery that is exempted from customs duties, these additional duties would also be lost, besides the tariff duties. For most products, additional duties exceed tariff duties and hence could substantially change the revenue calculations presented before. There are two types of additional duties levied on imports: (i) customs surcharges that are only levied on imports<sup>19</sup>, and (ii) internal taxes that are levied on imports as well as on domestic goods<sup>20</sup>. Importers are normally obliged to cover all of them. Each country has its own regulation on how it levies and calculates import duties. Often, different types of products are subject to varying rates, for example food products could be subject to reduced rates while luxury goods, tobacco or alcohol are often subject to increased rates.

How important are these duties compared to the tariff? How do they differ among countries and between developed and developing countries, given what we know about the differing tariff rates? First, compared to the tariff rates, the rates for additional duties are significantly higher: they amount on average to 23%, compared to only 6.9% for the tariff. The final calculation of the duties levied on imports therefore increases from 6.9 per cent (tariff only) to 29.2 % (tariff, customs surcharges, taxes). Second, the size of additional duties differs substantially among countries, ranging from 0 to 120%. In the case of tariffs, the developing countries were clearly the ones imposing (on average) higher rates than the developed countries. In the case of other duties, however, the rates between developed and developing countries do not differ considerably; averages calculated here amount to 23.1% for the former and 22.9% for the latter. This is largely due to the relatively high consumption taxes charged by many countries. They account for 15% (all countries), 17.1%, (developed countries) and 14.3% (developing countries) (Teltscher, 2000). Given the relatively high rates of additional duties on imports

<sup>19</sup> Customs surcharges usually consist of a mixture of duties, including undefined customs fees and uplifts or taxes such as statistical taxes, stamp taxes, or port taxes.

<sup>20</sup> Internal taxes are usually value-added taxes, sales taxes, or other types of consumption taxes.

of digitizable products, significant revenue increases resulting from these duties ought to be expected. The following can be observed (Fig 7.13 and 7.14): *First*, as far as absolute numbers are concerned revenues have jumped from US\$ 757 million (tariffs only) to US\$ 6.9 billion (tariffs plus additional import duties), an increase of more than 800%. Again, this is largely due to the high consumption tax rates levied on domestic goods and services: revenues from these taxes amount to US\$ 5.1 billion or almost 75% of the total (all countries) (Fig 7.15). *Second*, while revenues from tariff duties were almost double in the developing countries compared to the developed countries, revenues from all duties (tariffs, customs surcharges, taxes) are now much higher in the developed countries than in the developing countries: US\$ 5,3 billion compared to US\$ 1,3 billion for the developing countries. This amounts to a 78% share of the developed countries' import duties resulting from digitizable products, compared to a 22 %share for the developing countries. The developing countries' share is still significantly higher than their share in world imports of these products (16%). Again, a major explanation for these numbers is the consumption tax levied by the developed countries combined with their much larger trade volumes. *Third*, revenues from import duties and taxes on digitizable products now account on average for 0.3% of total government revenue, up from 0.06% (tariffs only). Their share in tax revenues has increased from 0.08% to 0.4%. In both cases, this is an increase of 400%. There is no major difference in these shares between developing and developed countries (Teltscher, 2001).



**Figure 7.14 Share of Digital product import duties in total import revenues, Source UNCTAD Calculations**

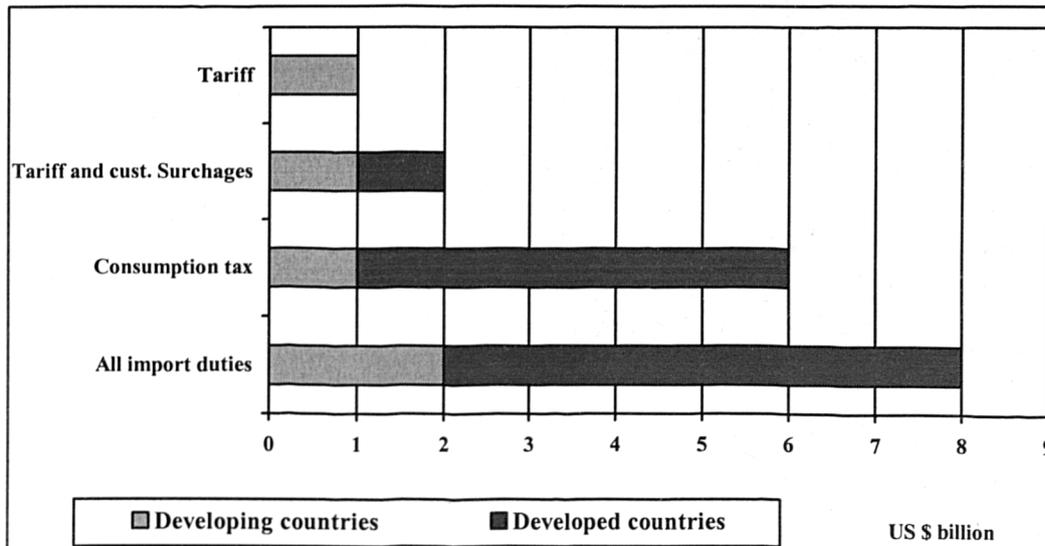


Figure 7.15 Digital Product Import Revenues, 1999

To summarize, fiscal losses resulting from replacing physical by digital products go much beyond simple tariff revenue losses. Almost all countries levy some sort of additional duties and/or taxes on their imports, which normally exceed tariff duties. These revenues could potentially be lost if goods were delivered digitally. The importer normally pays the duties and taxes identified here. In the case of online delivery, these intermediaries are eliminated and the product delivered directly to the final consumer. This could raise major problems in the area of tariff and tax collection, in particular if consumers are not registered businesses.

The concern is of increasing numbers of small and medium-sized enterprises (SMEs) that would be drawn in by e-commerce from the developing countries, which have little experience in international taxation issues. Any solutions must have the confidence of the developing world. "Above all, what is needed is a recognition that globalisation is not merely a matter of unrestricted market forces. It requires a strengthening of international standards and cooperative arrangements, to provide a basis of mutual confidence" (Picciotto, 2000). With a few exceptions, developing countries would not be part of any OECD agreement on Internet taxation. Nevertheless, they could use the principles and rules agreed upon as a basis for adjusting their own legislation. In addition, developing countries would attempt to use tax legislation, as they have in the past to attract private foreign direct investment (FDI). Multinationals increasingly operate in countries that have low taxes or are willing to negotiate favourable tax regimes to attract foreign business<sup>21</sup>. In fact, fiscal incentives are the most widely used type of FDI incentives<sup>22</sup>. Depending on the agreements adopted in the OECD, developing countries could negotiate specific bilateral treaties for e-commerce taxation, which would give them a competitive edge. For example, the transaction costs of setting up or moving a web server are low;

21 The Economist (2000), A Survey of E-commerce, 26 February 2000.

22 UNCTAD (1996). Incentives and Foreign Direct Investment, UNCTAD/DTCI/28, Current Studies, Series A, No. 30, Geneva

hence, e-commerce allows companies to respond quickly to tax incentives by Governments and move their web servers to a developing country. Any decisions, which developing countries may take on modifying their tax legislation to accommodate e-commerce, however, would have to take into account the significant role of tax and tariff revenues in their national budgets. Until new international agreements on e-commerce taxation have been defined, an increasing number of goods and services would be traded on-line, largely tax-free. This would have an effect on government revenue, especially if the goods and services have been subject to import duties in the past.

### **7.5 INDIA (AS A CASE STUDY FOR DEVELOPING COUNTRIES)**

The Indian economy has succeeded in maintaining one of the highest GDP growth rates in the world in the last decade with very low inflation, there are several areas where immediate improvements are required to sustain the growth momentum. On the fiscal side, while the government needs to focus on expenditure rationalization, a more critical area, which needs immediate attention, is to raise the declining tax to GDP ratio. On the external front, India's success in integrating into the world economy critically hinges upon raising the share of its exports in world trade closer to its pre-independence level of over 2% from the current level of 0.6%. In India, as in most federations, along with expenditure responsibilities, powers to levy taxes are divided in two layers of government, viz the Union and the state. In view of India's demonstrated capabilities in the InfoTech industry, it is expected that a fair share of growth would be experienced in India. This certainly calls for an initiative on the part of the Indian government to develop appropriate policies in relation to the taxation of e-commerce transactions. In order to examine taxation of Cross-Border E-Commerce transactions in India let me first analyse the concepts of taxation in India.

#### **7.5.1 INDIAN INCOME TAX LAW**

By the late 1960s and early 1970s, Scandinavia, the UK and other developed countries, as well as many developing nations, had legislated multiple and high individual income tax rates. Among the highest was India's, where it was well over 95%. Such high and multiple rates not only made tax administration very difficult, but also led to a state, especially in developed countries, where income tax evasion became widely accepted as standard behaviour. During this era, corporate income tax rates were also very high with most countries legislating rates between 50% and 60%. The expected negative ramification of such high marginal tax rates was that income tax became replete with exemptions, allowances, deductions, and incentives. What started as sectional and specific relief from high taxes were soon extended to facilitate and accommodate social or development goals? It was rarely analysed whether such tax exemptions actually achieved the desired objectives. However, these developed lives of their own and, in most countries, inevitably multiplied over time — driven by interests of specific

power groups at different points of time. India was no exemption. In India, any person, whether resident or not, is chargeable to tax in respect of his income accruing, arising, or received, or deemed to accrue, arise, or to be received in India. Thus, even if the income was not actually received in India but is deemed to accrue or arise in India, it would be taxable in India. Residents are taxed on their worldwide income, whether it accrues, arises, or is received outside India. Non-residents are taxed on their Indian-source income. The determination of a person's residential status becomes essential because taxability of a particular income and the rates at which it is taxed vary according to this status.

**A. Residence**

Any company incorporated in India is deemed resident in India even if its control and management are situated wholly or partly abroad. A non-Indian company is deemed resident in India only if its control and management are situated wholly in India. Thus, most foreign companies fall under the category of non-resident. The expression 'control and management' means, *de facto, control and management*, and not merely the right, power to control, or manage. Even if a part of the management and control were outside India, the company would not be considered resident in India. Thus, in one year, a company may be 'resident' in India and in another country; it may be 'non-resident'. Control and management is different from carrying on business operations of a company. It does not refer to control and management of the day-to-day affairs of the company's business, which is conducted by agents, employees, and servants. It is not situated where the shareholders meetings are held even if a single shareholder, due to his majority shareholding, has a decisive voice in matters relating to the company's affairs. It is situated where the central management and control actually resides. A company can have dual residence. Partnerships, associations of persons, and bodies of individuals are treated as residents of India, even if a fraction of their control and management lies in India.

**B. The Source Rule in India – Section 9 of the Indian Income Tax Act**

Section 9 of the *Income Tax Act, 1961* specifies various types of income that would be regarded as deemed to accrue or arise in India and, therefore, becomes taxable in India. The income is covered under this section when it is not chargeable based on its receipt. This principle is applicable to both residents and non-residents. For non-residents, unless the place of accrual or receipt of the income is within India, they cannot be subject to taxation in India (*Appendix A*).

• **Business Income**

Section 9(1)(i) of the *Income Tax Act* deals with the source rules for business income in India. Any direct or indirect income is deemed to accrue or arise in India so long as it is derived through or from: (i) Any property in India, (ii) business connection in India, (iii) any asset or source of income in India, or (iv) Transfer of capital asset situate in India. If not all operations of a business are carried out in

India, and then only the part of income that is attributable to Indian operations would be regarded as income accrued or arisen in India. The expression 'business connection' has a wide but uncertain meaning. The expression is not defined under the *Income Tax Act, 1961*. The concept of 'business connection'<sup>23</sup> is similar to but much wider in meaning than the concept of PE. The meaning of this expression is also not restricted to the definition of 'business'. The judicial precedents on the subject have evolved a meaning for this term, which could be summarised as follows: A business connection involves a relation between a business carried on by a non-resident that yields profits or gains and some activity in India, that contributes directly or indirectly to the earning of those profits or gains. Thus, to establish a business connection, an element of continuity should exist between the non-residents business and the activity in India. A business connection may exist even without any regular agency, branch, or other definite organization. The mere fact that a substantial part of the non-resident's output is sold in Indian markets, or is sold directly or through brokers to Indian consumers, or rendering of services outside India, per se, to a person carrying on business in India, would not amount to a business connection in India. Thus, if it were established that a non-resident has a business connection in India, then its income would be subject to Indian taxation under section 9 of the *Income Tax Act, 1961*. However, the tax would apply only to the income that is attributable to its activity in India. The tax rate applicable to business income of a foreign entity in India would be 48%, subject to the applicable tax treaty.

- **Royalty and Fees for Technical Services**

Section 9(1)(vi) of the *Income Tax Act, 1961* deals with the source rules in respect to royalty income. Royalty<sup>24</sup> income is deemed to accrue or arise in India if it's paid either by a resident or a non-resident for any right, property, information, or services utilized for carrying on a business in India. Similarly, section 9(1)(vii) lays down the source rules for fees for technical services (Appendices). Once again, the fee is deemed to accrue or arise in India if a resident pays it or a non-resident for any services utilized for carrying on a business in India. The definition of fees for technical services under the *Income Tax Act, 1961* is much wider than that under most double taxation avoidance agreements that India has entered into. The rate of tax applicable to the income of a foreign company by way of royalties and fees for technical services is 20%, as set forth in section 115 A of the *Income Tax Act*.

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23 India is perhaps the only country to have court pronouncements on the direct tax issues arising out of cross border trade between independent states and British India. Before independence, the Allahabad High Court considered the scope of words 'business connection' in a case where cloth manufactured in an independent state was sold in a part of what was then the British India. The sale was through brokers who were not the employees of the enterprise and who were not canvassing only for the enterprise. The Court held that there was no 'business connection' in British India. The Supreme Court defined the scope of 'business connection' in the case of a French textile company in following words: 'When there is a continuity of business relationship between the person in British India who helps to make the profits and the person outside British India who receives or realises the profits, such relationship would constitute a 'business connection.'

24 For the Definition of Royalty see Appendix A

**C. E-Commerce: Illustrative Case Studies**

Tax incentive based on 'infant industry argument' is not acceptable as e-commerce is 'up and running as fast as any other economic infant in history'. Also 'infant industries' granted preferential tax treatment typically never grows up. Temporary preferential treatments tend to become permanent. The Indian *Income tax Act, 1961* has many such examples. In India, the tax department has identified electronic transactions carried on by MNCs, such as credit card and airline reservations businesses, as a major source of revenue. A perusal of taxation of the CRS activities in India will prove to be a useful case study for the purpose of this analysis. This case will bring about clearly, some of the issues regarding the challenges posed to the prevalent definitions of PE by e-commerce.

- **Advance Ruling on the taxation of Credit Card Companies in India:**

The ruling delivered by the Authority for Advance Ruling (AAR) is on the taxability of income of foreign companies engaged in the operation of credit cards and travellers cheques. The payment made by the Indian Company for accessing the foreign company's computer system in USA has been held to be royalty income and therefore taxable in India. The facts of the case are as follows:

The applicant, Y, was a company incorporated in USA and belonged to 'ABC' group of companies, which operated in the worldwide credit card and travel business. XT was an Indian company and was registered as a 100% export oriented unit in India. It provided customer services, mainly by way of data processing to 13 companies of the ABC Group located all over the world. It had its main object of operation of a high technology centre for data management and information analysis and control of ABC group and other companies in Asia, Europe, or elsewhere. The income of XT was received in foreign exchange for export of software and therefore it was exempted from tax under section 80HHE of the *Income Tax Act, 1961*. 'Y' had worldwide information processing telecommunication centre at USA. It owned and maintained huge high tech computers and other software and hardware facilities capable of high volume storage and high speed processing of data. Y allowed its customers to use its central processing unit (CPU), which was at USA against payment. XT also used Y's CPU, which was at USA to meet part of its processing needs. Y's CPU was also accessed by various 'ABC' entities located worldwide through a Consolidated Data Network (CDN) maintained in Hong Kong. XT had a link up to CDN through dedicated international leased circuit lines of Videsh Sanchar Nigam Limited (VSNL). It had entered into agreement with Y for the use of CPU and CDN, which mentioned that XT would make payment to Y after withholding necessary taxes.

- **A typical transaction is explained as follows:**

The transaction done by a traveller in a particular country is reported to a centralised computer in that country. In India, this was done by XT, which was at Delhi. It received information on computer

through telephonic or microwave links about the use of credit cards and travellers' cheques by travellers all over the country. XT used the software developed by the applicant available in computer system. It fed data into the computer system and retrieved the processed data from it. The access to the CDN maintained at Hong Kong and CPU at USA was made available to XT through VSNL satellite link. The information from all over the world was sent to India, processed and sent back. The applicant (Y) charged XT for the use of its computer set up in Hong Kong and in USA. The questions raised before the AAR were as follows: whether the charges receivable by the applicant Y from XT for the use of its CPU at USA and CDN at Hong Kong would be taxable in India? If yes, would the payment due to the applicant be covered under Article 12(3)(a) or Article 12(3)(b) of the Double Taxation Avoidance Agreement (DTAA) between India and USA, which relates to Royalty and fees for technical services respectively?

The AAR commented that the CPU of the applicant in USA has its own software and is operated by its own personnel in USA. XT is retrieving from the CPU the processed data of its customers and makes payment to Y only for having access to the data and use of computer system. This clearly establishes that the software used in the CPU is that of the applicant and it has allowed Y to use its software. XT accesses the CDN computer system at Hong Kong and through that, it accesses the CPU in USA. At both the stages, XT is allowed to use the software developed and protected by the Applicant Company<sup>25</sup>. AAR suggested that the following are the main ingredients for characterising any payment as royalty payment:

- It is a payment made in return for a right to exercise a beneficial privilege or right,
- the payment is made to the person who owns the right,
- the consideration payable is determined based on the amount of use.

In the instant case, these tests cover the CPU/CDN charges payable by XT. The AAR further commented that globally, enterprises are becoming completely networked, more so in the field of software. Y in the present case is a service provider, which '*inter alia*' allows XT to use its bandwidth as also its networking-infrastructure for the consideration spelt out in the agreement. XT not only collects the data regarding the use of travel documents by the applicant's clients in India and transmits it to the multi-location electronic set up of the applicant, it also provides various other services such as sending daily and monthly records of bills and payments to its service establishments. The definition of 'royalty' under section 9(1)(vi) of the Income Tax Act 1961 and explanation 2(vi) include rendering of any services in connection with any activities for use of patent, invention, secret formula or process etc. Hence, the concept of 'source' as against 'residence' becomes more significant as the issue related to cyberspace activities. The transmission of information is through encryption as the data relates to

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25 Reference was also made to Klaus Vogel's commentary on DTAA (para 9 page 784), narrating the view of United States on payment for using of software by virtue of contract as follows: "The United States believes that in interpreting the definition of 'royalties' in paragraph 2 of the article, with respect to payments for software, it should be understood that where a payment for the acquisition of software for the personal or business use of the purchaser is measured by reference to the productivity or use of such software, the payment may represent a royalty under the article."

clients and strict confidentiality is observed. It is for the downloading of the software that the royalty is paid. In this context, source rule becomes relevant which requires that the royalty be sourced in the state of the payer. The consideration payable by XT is for the specific program through which XT is able to cater to the needs of ABC companies. The AAR referred to Klaus Vogel's commentary to support the view that the transaction would relate to a 'scientific work' and would partake of the character of intellectual property.

The AAR ruled that XT not only uses the CPU and CDN of the applicant as equipment but the software used is specifically developed by the applicant company under the agreement entered into between XT and Y. The software is customised and secret. From the facilities provided by the applicant to the Indian company, which are in the nature of online, analytical data processing, it would be clear that the payment has been received as 'consideration for use of, or the right to use... design or model, plan, secret formula or process...' within the meaning of the term 'royalties' in article 12(3)(a) of the DTAA and therefore, would be taxable at the rate of 20% for the first five years of the DTAA coming into effect and thereafter at the rate of 15%. The AAR delivered ruling in favour of the tax department and considered the payment received by US Company from Indian Company for the use of the computer systems situated abroad taxable in India as 'royalty' income.

### 7.5.2 SALES TAX

Of the total tax revenue of the states raised in 1992-93 and 1993-94, nearly 60% came from sales tax. In India, the power to levy sales tax within a given state belongs exclusively to the state concerned (subject to some restrictions). This is because the assignment of tax powers under the Indian Constitution is based on the principle of separation as distinguished from concurrence. Pattern of inter-State sales of goods depends upon the place wherefrom the movement of goods commences and the destination at which such movement terminates. The *Central Sales Tax Act, 1956 (CST)* therefore, classified sales of goods with the three broad divisions, namely, (1) Intra-State sales, that is those sales in which the movement of goods commences, as well as, terminates within the boundaries of one and the same state; (2) Inter- State sales, that is those sales wherein the movement of goods commences in one State, crosses its boundaries and terminates in another State and (3) In the course of import into or export out of the territory of India. The inter-state sales are liable to tax under the *CST Act, 1956* by the state of origin. 4 % tax is generally levied on all inter-State sales. On an average about 17% of the revenue of the states from sales tax comes from the CST, in some states the proportion is as high as 34-35% while in some it is no more than 7%<sup>26</sup>. State sales taxes that apply on sales made within a State have rates that range from 4 to 15%. Sales tax is also charged on works contracts in most States and the value of contracts subject to tax and the tax rate vary from State to State. For revenue reasons, in India sales taxes are levied on all commodities including inputs and capital goods, while because of constitutional limitations, services are excluded from the tax base discriminating against goods and in

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<sup>26</sup> Source Reserve Bank of India Bulletins 1995-96.

favour of services. This has given rise to interminable problems in separating out the services component in the sale of goods taking place.

Sales tax is levied on the seller who recovers it from the customer at the time of sale. The state from which movement of goods commences collects these taxes on behalf of the centre and retains the proceeds of the taxes. Where the sale takes place in the course of import into India, or export out of India, no tax is leviable under the *Central Sales Tax Act, 1956* or the state Sales Tax Laws<sup>27</sup>. Because of administrative ease, in India sales taxes have come to be applied increasingly at the first stage of sale in a state with the base overlapping considerably with that of central excises and in absence of adequate relief for tax paid on inputs, this leads to cascading and several other undesirable effects. The specific issue that e-commerce would give rise to is situs of a sale, which I have discussed earlier. In the case of corporeal or tangible goods, which are specific or ascertained, their sale is deemed to take place in the state in which they are at the time the contract of sale is made. In the case of unascertained or future goods, the sale is deemed to take place in the state in which the goods are at the time of their appropriation to the contract of sale by the seller or by the buyer (Section 4 (2) of the *Central Sales Tax Act*). Therefore, the time of conclusion of the contract is of critical importance to the question of situs (*Appendix B*).

**A. The power to levy Sales tax**

Article 286 of the Constitution of India imposed certain restrictions on the sales taxation powers of the states. These restrictions were intended to prevent them from taxing (i) sales or purchases in the course of trade outside the territories of India; (ii) sales outside the state of levy where they result in delivery or consumption of goods in another state; and (iii) sales in the course of inter-State trade and commerce. It can be easily seen that the rationale underlying the restrictions that debarred the states from taxing the sale of goods the resulted in delivery and consumption in another state was to ensure that sales taxation in the country proceed according to the principle of destination. The implications of the restrictions on the states' power to tax inter-state sales as stipulated in the article quoted above were explained by the Supreme Court in a case that came before it in the following words: *'Article 286(1)(a) read with the Explanation prohibits taxation of sales or purchases involving inter-state elements by all states except the states in which the goods are delivered for the purpose of consumption therein. The latter state is left free to tax such sales or purchases which power it derives not by virtue of the Explanation but under article 246(3) read with Entry 54 of List II'*.<sup>28</sup>

The Constitution was amended in 1956 (Sixth Amendment Act). The Explanation in Article 286 (1) that sought to enjoin the destination principle was dropped and entries were added to the Seventh

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<sup>27</sup> For Import and export out of the Territory of India have been given an immunity from taxation Constitution, Schedule VII, List II, entry 54; Schedule VII, List I, entry 92A and Article 286 respectively.

<sup>28</sup> Taxation Enquiry Commission, 1953-54, Vol. III

Schedule to the Constitution to empower the Centre to levy tax on inter-state sales with the stipulation that it would be one of the taxes which can be levied and collected by the Centre but the proceeds will be 'assigned' to the states. This in brief is the origin based inter-state sales taxation in India.

### **B. Main Principles in State Sales Tax Laws**

- A sale or purchase of goods is said to take place when the transfer of property in the existing goods or future goods takes place for consideration of money.
- The goods have been divided into different categories and different rates of sales tax are charged for different categories of goods.
- In most of the cases related to the sales tax, the tax on the sale or purchase of goods is at single point.
- Under the provisions of some state laws the assesses are divided into several categories such as manufacturer, dealer, selling agent etc. and such as assess is required to obtain a registration certificate to that effect. The sales tax or the purchase tax is levied on that assessee on the basis of his category such as dealer, manufacturer etc. on production of certain forms or certificates (and differential rates of sales tax are levied).
- Transactions not amounting to inter-state sales:  
Not all dispatches of goods from one state to another result in inter state sales rather the movement must be because of a covenant or incident of the contract of sales. There are some instances wherein the goods are moved out of the selling state and yet they are not considered inter state sales: Intra-state sales; Stock transfer from head office to branch & vice versa ; Import and Export sales or purchases; Sale through commission agent /on account sales; Delivery of Goods for executing works contract (*Appendix B*).

### **7.5.3 INFERENCE**

The main object of the above discussion on sales tax in India was to draw the principles, which are now applicable for sales tax. These characteristics of sales tax a system in India have given rise to many acute problems: complexity, lack of transparency, and distortions in economic decisions and inequities in inter-jurisdictional division of tax bases. Conceptually pure versions of Indian sales tax, US sales tax and EU VAT have similar effects, but there are inherent administrative differences in the three taxes. Particularly important for present purposes are: (1) the treatment of sales of services and intangible products under the three taxes (such products are generally taxable under the VAT, but not state sales taxes), (2) the treatment of purchases by business (VATs on such purchases are almost universally creditable against VATs on sales, but many such purchases are subject to state sales tax), and (3) the treatment of sales between jurisdictions (they are commonly subject to VAT in the country of

destination but exempt from sales tax in states where the vendor lacks a physical presence, which quite similar to US state sales tax).

While e-commerce raises important issues that may seem to be new (for example, the continued viability of primary reliance on source-based taxation of income), in many cases it only accentuates problems that were there all along (for example, the structure of state sales taxes and CST in India). Thus, some of the reforms needed are not only related to do with the taxation of e-commerce, per se, than with commonsense reforms that have long been needed. I believe strongly that the commonly accepted goal of a level playing field for e-commerce cannot be achieved without addressing these more fundamental problems, especially in the state sales tax area. The ability to deliver the same goods and services in a variety of competing ways changes the nature of competition and places a high premium on economic neutrality and equity in tax policy. The costs of illuminating manuscripts were so much greater than those of printing them that taxation of printed matter would probably have had little impact on the choice of technology, unless truly confiscatory, but it seems reasonable to assert that substantial differences in taxation could have been tolerated without doing as much damage to neutrality or equity (or both) as in the case of competition between digital and pre-digital means of delivering information. The same is not true of competing ways of providing essentially identical goods and services (for example, software in 'canned' form or downloaded; books by mail order, downloading, or conventional retail sales) produced and distributed under market conditions that increasingly approach perfection. The problem for India CST starts here; services are tax-free while goods are not, but how to distinguish them in the virtual world?

As a classical developing country situation, there is intense tax competition among the states to attract trade and industry to their respective jurisdictions. Generous concessions are offered to new industries, small industries and industrial units set up in backward areas through tax holidays and or deferral tax payment by all most all the states to the detriment of revenue, as well as equity and causing problems for both enforcement and compliance. A website can reap all the benefits with out contributing anything for the development of local economy. The tax base is itself quite narrow with exclusion of services and concessions of various kinds, not mention widespread evasion because of administrative weakness, in order to counter balance the further loss of revenue due to e-commerce the rates of tax have to be higher than would otherwise be necessary to collect the same amount of revenue, providing further impetus for evasion.

Tax policy considerations suggest that sales taxes should be imposed on a destination basis that tax should be collected by the jurisdiction where consumption occurs, not where production occurs. Yet, for technical reasons, sellers of electronic content may not know the destination of sales made over the Internet. Thus, taxpayers may not even know the location of their customers. It is more difficult to monitor the transmittal of electronic signals than to monitor trade in tangible products, especially when the transmission network is becoming so widely decentralized and location plays such a small role.

Secure methods of payment, which are needed for commerce to flourish, may impose significant impediments to tax administration. The 'audit trails' needed for tax administration may no longer exist (for example, where electronic cash or smart cards are used for payments). It may be possible to determine the total sales, revenues, or income of a vendor, but impossible to know where some sales are made. It may not even be possible to know total revenues from sales, since it is not possible to utilize physical examinations (for example, of the movement of inventories) as a back-stop to auditing of accounts, since electronic content (intangible products and services provided on-line) has no physical form. As The Economist noted, "*If a firm sells software on floppy disks then the number of blank disks purchased can be used to verify sales. But if the software is sold electronically, there is no corroborating evidence.*"<sup>29</sup> It notes that European countries are having difficulties collecting VAT even on shipments of tangible products such as compact disks and that 'policing products downloaded electronically--music and videos--will be even trickier.'

In past pressure for revenue has impelled many states to go in for supplementary levies in the form of surcharges, additional sales tax and, in many cases, a turnover tax applicable at different stages of sale resulting in lack of transparency and uncertainty and, for several sectors, an unduly heavy burden of tax. That in turn generated pressures for further concessions for selected sectors and sections with the result that rates vary widely across commodities depending on their classification in the rate schedule which is based on distinctions that are often hair-splitting, requiring judicial arbitration. Cases were taken to court to decide questions such as whether 'coconut' is fruit or oilseed. The Indian states do not attempt to identify precisely the corporate income that originates within their boundaries. Instead, they employ formula apportionment to determine the portion of the income of multi-jurisdictional corporations they will tax, taxing a fraction of such income equal to the weighted average of the fractions of various economic activities of the corporation (or unitary corporate group, in the case of unitary combination) that occur within their boundaries. Commonly these 'apportionment factors' are payroll, property, and sales. Whereas historically the three factors have been weighted equally, more recently, higher weight has been accorded to sales, presumably to reduce the likelihood that taxation of corporate income will discourage economic activity in the taxing state. This strategy may not be effective in the area of e-commerce; because of the way, receipts from the sale of services and intangibles are commonly treated in apportionment formulas.

As noted above, the property factor does not include intangible property. This is a major omission in industries where intangible assets are 'the franchise' as is the case in many aspects of electronic commerce in content (services and intangible products). Yet, it is inherently difficult--indeed, perhaps impossible--to know the location of an intangible asset. For non-tax reasons (having to do partly with limitations of copyright laws), much of the intangible property that moves in electronic commerce, especially 'shrink-wrapped' (canned) software sold in mass markets, is licensed for use by the licensee, not sold. It could be argued that, where this is true, such property, in principle, should be included in

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<sup>29</sup> Taxes Slip Through the Net, Economist, May 31, 1997, at p 22

the property factor of the seller/licensor, which retains ownership of the underlying asset. Doing so would raise difficult compliance problems regarding where the asset is located, over and above the question of how to treat license receipts in the sales factor. It seems far more practical to treat licenses of canned software as sales. In that case, business buyers operating in multiple jurisdictions would face the issue of where these assets are located, whether they remain in use, and their value. Since the CST applies only when there is sale, goods moving from one state to another on a consignment basis (branch transfer) are not liable to tax. This will open new opportunities of evasion/avoidance for the e-commerce companies. Moreover each state has its own laws and procedures prescribing different schedules and forms for compliance the number of forms in some cases run to over 40.

Another source of problem and dispute is the exclusion of services from the tax base. As noted above, sales of intangible products commonly are attributed to the state where the greatest cost of performance occurs. This approach is fraught with conceptual and practical problems. Most obviously, attributing sales of services and intangible property to the state where economic activity/cost of performance occurs is quite inconsistent with the attribution of sales of tangible personal property to the state of destination. This difference can cause distortions. Thus, for example (leaving aside issues of nexus), the sale of content (for example, music, videos, information, software) is likely to have substantially different tax consequences, depending on whether the sale takes a tangible form (sales attributed to the purchaser's state) or an intangible form (attribution to the state or states where cost of performance occurs). The use of cost of performance in the sales factor for non-tangible sales can have perverse effects on the location of economic activity. As noted above, some states will increase the weight on the sales factor, presumably to reduce the weight on activities related to production. This is not an effective strategy in the case of sales of intangible products, including electronic commerce in content, unless the state also moves to adopt a market-related measure of the sales factor.

E-commerce will facilitate the direct imports by households, creating problems of detection and valuation under CST, as there is no sales tax on import, most of these will go tax free, even though there is sufficient provision for customs. India gets 18% of its income from tariffs. According to an ASSOCHAM (2000) report<sup>30</sup>, India imported digitizable media products to the extent of US\$ 198 million in 1996 when the applied tariff rate was 26%. The estimated tariff revenue was US\$ 51.3 million. Assuming that the digitizable media products account for 50% of total products which were delivered in digitizable form, the revenue loss would be about US\$ 100 million, which would be about 1% of the total revenue coming from import duties. However, this report did not take into account e-commerce services, such as financial, travel, architectural design, etc. Based on this analysis it clear that is potentially much more revenue loss than what was actually suggested. The access to the capital (both physical and human) needed to benefit from e-commerce is almost certainly more readily available to the affluent than to those of more modest means. For example, Frieden and Porter (1996)

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30 ASSOCHAM (2000), 'Backgrounder for Conference on E-commerce Implications for India', ASSOCHAM, New Delhi.

reported that 64% of Internet users have a college degree, compared with 28% of the entire U.S. population (Frieden and Porter, 1996). Hammond notes the following comparisons of users of the Web and the entire population of the United States and Canada, based on survey results: income in excess of \$80,000--25% vs. 10%; professional and management occupations--50% vs. 27%; college graduates--64% vs. 29% (Hammond, 1996). This means that favouritism toward e-commerce is likely to imply vertical inequities: relatively higher taxes on the poor than on the affluent (The Economist, 1997). In a joint press release, the National Governors' Association, the National Conference of State Legislatures, the National Association of Counties, the National League of Cities, and the United Conference of Mayors argue, "*individuals with the resources to purchase a high-speed personal computer enabling them to use the Internet to make purchases that most Americans make in local stores are not a class of taxpayers needing an exemption from state sales taxes*". In a developing country like India, the disparity in level of Income between rich and the poor is so extensive that any change in the indirect tax will have profound and damaging influence over the economic condition of the poor.

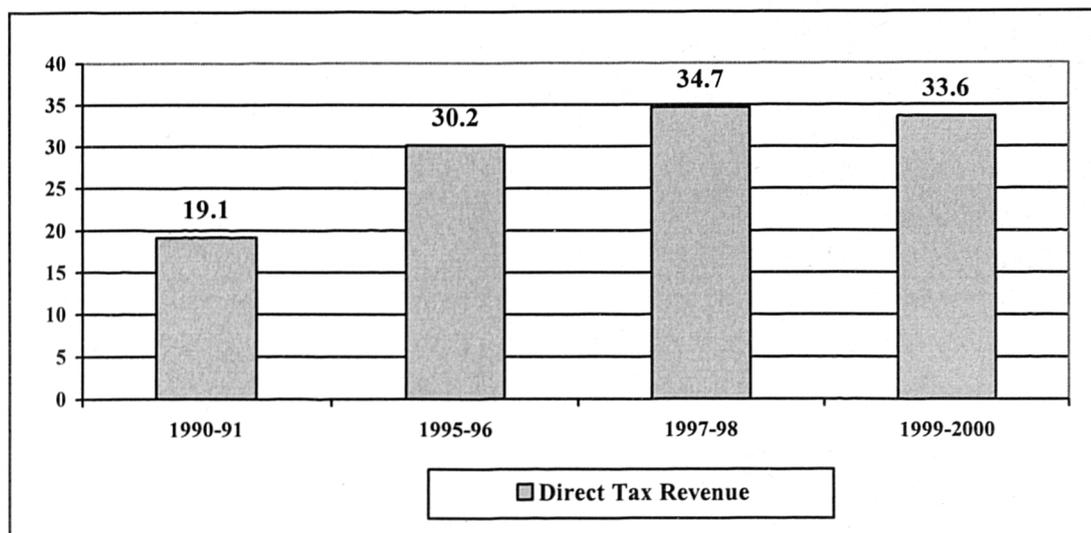
### 7.5.4 REVENUE SHARE

Estimating the reductions in the sales tax base and then multiplying the lost tax base by effective state sales tax rate or the central sales tax rate can measure probable revenue losses from e-commerce sales. Key inputs to estimating the tax base loss for e-commerce transactions are forecasts of e-commerce sales, identification of the sales taxable components of these sales, assumptions about what share of taxable sales could be collected in the absence of e-commerce, and estimates of the share of taxes due that can be collected. Data regarding likely trade outflows and trade inflows through cross border e-commerce, in India is not available. Separate data for e-commerce involving digitised delivery, which affects direct and indirect taxation in a crucial manner, is not available for India or any other country.<sup>31</sup>

Tax revenue as a percentage of GDP has slipped since the inception of reforms, which started since 1991-92 from over 16% to around 14%. The decline has been caused by a fall in indirect taxes. The share of direct taxes in the gross revenue has increased over the years (Fig 7.16).

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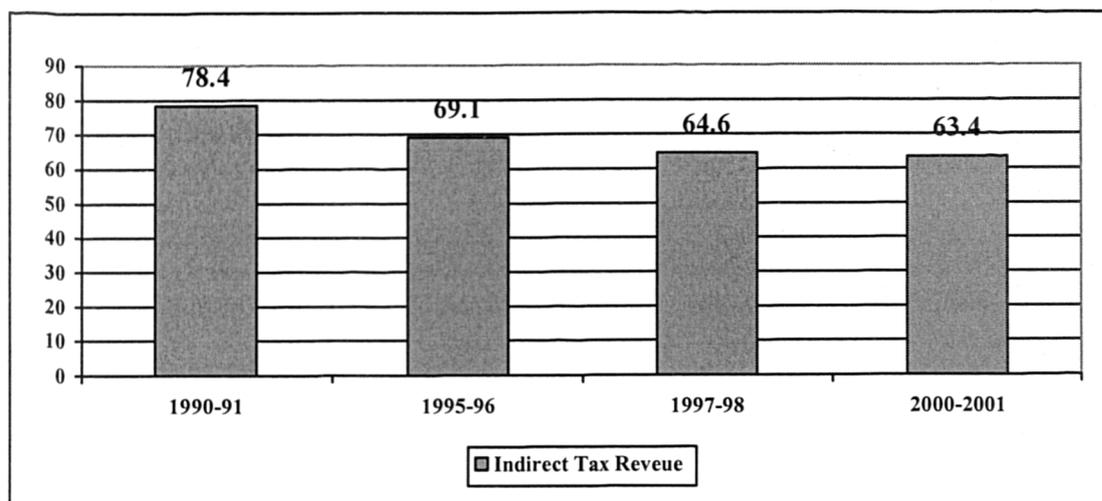
<sup>31</sup> Report to Government of India by the Committee on E-Commerce Taxation, at p 8, 2001.



**Figure 7.16: Direct Tax Revenue (India)**

**Source: Tax figures as per Controller General Accounts Budget 1999-2000  
Government of India**

Correspondingly, the share of indirect taxes in gross tax revenue declined substantially during this period (Fig 7.17).



**Figure 7.17: Indirect Tax Revenue (India)**

**Source: Tax figures as per Controller General Accounts**

Four main taxes are levied by the Central Government of India are, the Personal Income Tax, Corporation Tax, Customs duties and Union excise duties. Custom duties have remained a major source of revenue of the Central Government along with the Union Excise duties. Income tax has never been a source of good tax gatherer. The share of custom duties to tax revenue has increased from 21% in 1970-71 to 45% in 1992-93, whereas that of union excise has decreased from 56% to 32%. The share of Income Tax has remained almost the same i.e. around twenty percent of the total revenue of the Central Government. The main sources of tax revenue of the State Governments are; the share of the states in the Union Excise Duties, Commercial taxes such as the Sales Tax, Entertainment Tax, Land Revenue, Stamp duties, State Excise duties on alcohol and narcotics. Land Revenue is an inelastic tax and its contribution to State's revenue has declined from about 10 percent in 1967-68 to just 1% in

1992-93. Thus, the states have to rely heavily on Sales Tax as its Chief source of revenue, which constituted 39.9% of state governments tax revenue in 1992-93. A study of the revenue from direct taxes (Taxes on income and expenditure and Taxes on property and capital transactions) and indirect taxes (Taxes on commodities and services), exhibits the following features: (i) The share of indirect taxes in tax revenue has always been higher as compared to direct taxes. This is mainly because of the low per capital incomes of the people, (ii) the share of indirect taxes in total tax revenue has been steadily rising over the years. It was Rs. 227 crores - 1950-51 and it has increased to Rs. 45,480 -1992-93 currently it accounts for nearly 80% of the total tax revenue, iii) As regards the distribution of burden of indirect taxes, studies indicate that the structure of indirect taxes is progressive with reference to expenditure, but the burden of taxes fall on the poorest section of society, iv) The share of direct taxes in the total tax revenue has been coming down over the years from 36% to 19% between 1950 and 1993.

Year	Direct taxes	Percentage of total	Indirect Taxes	Percentage of Total	Total Tax Revenue
1950-51	130	36	227	64	357
1992-93	10,980	19	45,480	81	56,460

**Table 7.2: Position of Direct and Indirect Taxes (in crores)**

**(1 Crore is equal to 10 million rupees)**

There are several factors which are responsible for insufficient increase in direct tax revenues especially income tax. *Firstly*, an all India average of 0.29% of the people who pay direct taxes. The number of income tax payers in 1980-81 was 4.6 million and this has increased to 7.5 in 1990-91. The increase is marginal. *Secondly*, there are a large number of people in India who practice tax evasion on a large scale. Hence, the burden of direct tax falls mostly on the tax groups who cannot practice tax evasion. If tax evasion were checked, it would lead to greater equity and higher revenue for the Government. *Thirdly*, lack of efficiency in tax administration and existence of corruption in administrative staff is also responsible for tax evasion in relation to direct taxes.

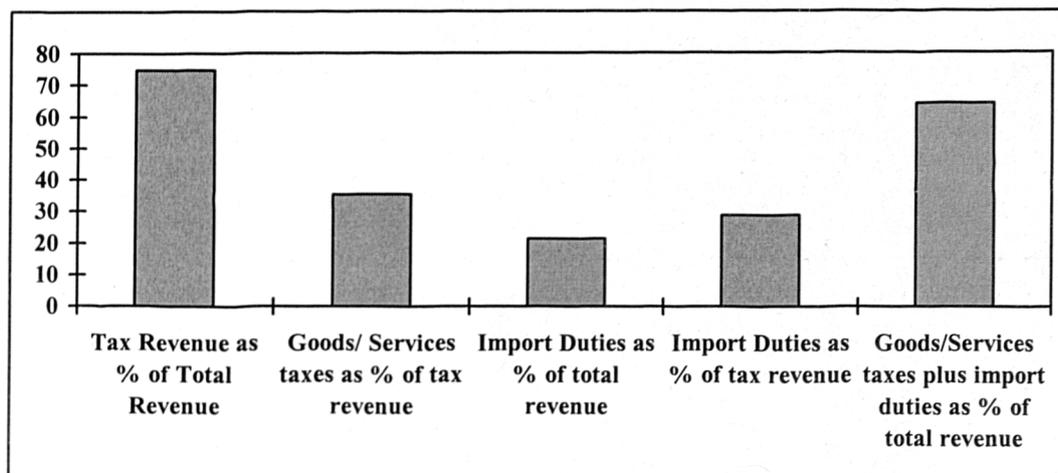


Figure 7.18: Government of India Revenue Share, Source IMF Year Book 1999

Indirect taxes on the other hand can be effectively used for obtaining higher revenue yields. *Firstly*, they are easier to impose and their rates can be revised with comparative ease. *Secondly*, they have a wider coverage and number of people contributing towards these taxes is always larger. *Thirdly*, appropriate changes in the rates of these taxes could lead encouragement of investment in different commodities and areas and a better allocation of resources in different sectors of the economy. Levying appropriate indirect taxes can encourage balanced economic development. *Fourthly*, indirect taxes can be made progressive by imposing, higher taxes on luxury goods, and lower taxes on goods for mass consumption. Taxation has been contributing towards 80% of the public expenditure. Indian tax system is, thus quite extensive in its coverage. The incoming changes in the taxation policy have raised the taxable revenues. Taxation had not only increased revenue of the government but has also been successful in inducing productive investment of late, the task of welfare channelisation depends to a large extent on the taxable revenues of the government. The government has been taking adequate measures to make the tax structure effective and efficient. The following notable features of the tax system can be drawn up: (i) The heavy reliance on indirect taxation in the tax system indicates the need to recast the tax structure, ii) The high duties being imposed on goods of mass consumption need to be reduced or exempted to reduce the burden of tax on the poorer income groups and making them less regressive, iii) Greater elasticity in the tax system would bring about a built in flexibility. Flexibility leads to increase in tax proceeds at a much faster pace as compared to increase in the national income. Excise duties, corporation tax sales tax are considered elastic, whereas land revenue and income tax have very low elasticity. iv) The Indian tax system is not administratively efficient. The every changing fiscal objectives and changing tax structure to achieve these objectives, such as reducing regional disparities, increasing employment and capital formation, etc. the administrative efficiency has deteriorated Simplification of tax laws is the need of the hour. v) Lack of integration and multiple tax system is a source of concern. Multiplicity of taxes encourages tax evasion and reduces administrative efficiency. vi) The taxation policy of the government has been encouraging distortion in prices of various goods and services. The multi-point system of taxation implies imposition of taxes at various

stages in the production of a commodity and finally an increase in its price. The cost of production for the producers also automatically rises, which is passed on to the consumers in the nature of high priced goods. vii) Proper planning of the tax-structure to bring about a mix, so that labour intensive enterprises are encouraged along with capital intensive enterprises to that development moves at a faster pace with due importance provided in the employment aspect.

In a developing welfare economy, it is necessary that a distributive effect of taxation bring about socio-economic justice. The richer income group would voluntarily not transfer their surplus resources in the interest of the weaker section of the society. Hence, taxation is required to act as a force, which carries forward the task of transferring resources from private sector to public sector. In the Indian economy, the economic inequality is bound to exist. Hence, taxation is required to reduce inequalities first by raising the slab of taxes for the richer come groups and second by making productive utilisation of the tax revenue. It is also desirable that redistribution programme is carried on by raising the incomes of the poor rather than by cutting it down from the upper end. However, a Finance Minister has to assign due weight age to progressive character of taxation. For the smooth functioning of economy, it is essential that persons from all occupations extend enormous co-operation to the government. Within the Indian system, a major issue is taxing the new breed of taxpayers. *Taxation authorities should not discriminate against two like establishments. Mostly only large organizations trade on the Internet. If they get away, that means they do not pay taxes, their goods become cheaper. So in that sense, evasion will occur, which will support larger organisations. The smaller organisations evade taxes physically, while technology aids larger organisations. The kind of advantage technology offers is phenomenal. Therefore, when people start buying from larger organisations, it creates an uncompetitive environment, unless the rest of the economy can also use these new technologies. The idea is any administration of tax laws should keep everybody equally competitive and should not create a barrier against efficiency and equality.*

In the Internet economy, India as most of the developing countries is at generation one. At present India is at way behind where USA was in 96. Internet economy began in 94. The total value of India's Internet economy today is where USA was in 93. The result of which is huge governmental incentives tax cuts for this sector. Import duty for specified inputs and capital goods for Information and Technology were reduced, but there is not many options left for the government to counter balance it. A study on carried out on the subject of sales tax in India at National Institute of Public Finance and Policy (NIPFP) sums up: *"The system that is operating at present is archaic, irrational and complex-according to knowledgeable experts, the most complex in the world"*. Other exemptions are intended to improve equity, such as the exemption of food for consumption at home and prescription drugs. These equity enhancing exemptions may come at a high price in terms of targeting and of administration and compliance, and improved equity may be better achieved in most states though direct taxes. Still other exemptions are given mostly for political reasons. These exemptions are often for business inputs, which should be excluded from a consumption tax, but they are given in a haphazard fashion that may

not be efficiency enhancing. For example, the exemptions are often firm specific or are very narrowly construed, and can lead to differential taxation within industries.

#### **7.5.5 INITIATIVES TAKEN BY THE INDIAN GOVERNMENT**

It is widely accepted that a significant portion of potential tax revenue is not collected because of poor tax administration and high tax evasion in India. The question is whether the complexity of the tax structure or high tax rates have led to a high incidence of tax evasion, or if lax tax administration by itself has been unable to fulfil the revenue objectives implied by the tax structure. In practice, it is likely that both tax policy and tax administration have mutually affected each other. It is widely recognized that tax policy and tax administrations are intrinsically linked. In this interrelationship, however, tax policy formulation is generally seen to precede tax administration. This is because only when a tax structure is legislated does tax administration come to play its role in the implementation of the law. In developing countries, however, the direction of the link may not be quite so apparent. Indeed, it is said that in developing countries tax administration is tax policy (Bird and Casanegra, 1992). This would imply that, however fine the design of the tax structure might be in a representative developing country, it is the interpretation and implementation of the law that counts. These elements reflect the need for adequate capacity of the tax administration in place to implement the law (Faria and Yucelik 1995). At the same time, experience reveals that a particular tax administration mechanism could alter the original intention of tax policy and structure. Possible modes include large taxpayer units that continue to be. In many developing countries, tax laws may be quite well designed and detailed. However, unless the accompanying tax administration is able to handle those laws in terms of having the appropriate staff to interpret and implement them, the field-level reality of the actual incidence of the tax system may be quite different from the original objectives (Faria and Yucelik, 1995).

An ideal tax system in developing countries need to raise essential revenue without excessive government borrowing and should do so without discouraging economic activity and without deviating too much from tax systems in other countries. Virtually everyone agrees that the current state of affairs is untenable. Unfortunately, there is no possibility of a quick fix that deals only with electronic commerce, narrowly defined. A satisfactory resolution is likely to involve a fundamental reform that goes well beyond e-commerce. Examining the results of an attempt to address only issues directly involving e-commerce can see this. Most fundamentally, the states would be left to do as they wish, subject only to general constitutional constraints. The argument that tax exemption is justified to ensure unhindered growth of e-commerce lacks force as any economic activity, and not just e-commerce, would, in theory, grow faster if it were tax exempt. Tax exemption could perhaps be justified in case taxation is shown to be a constraint to the healthy growth of e-commerce. The e-commerce has achieved unparalleled growth not only in the developed countries but also in a large number of developing countries including India. A Goldman Sach's study expects average annual growth in e-

commerce in India at 246 percent, higher than any other Asian nation and Australia. The total volume of e-commerce transactions in India was about Rs 450 cores in 1999-2000. The NASSCOM survey revealed that it is expected to exceed Rs.2, 300 crore in 2000-01 and go up Rs 40,000 crore in 2003-04<sup>32</sup>. The growth of domestic software market is expected to gross \$2.7 billion in 2001-02 and IT Software and service sector continues to be amongst the fastest growing sector in the Indian economy. The available data does not give separate estimates for domestic and cross border e-commerce in India.

Transforming the existing complex, cascading type, partly origin based sales taxes levied by the states into a simple destination based value added taxation is not just an option, but an imperative. Therefore, consensus in the conference of state finance ministers was to transform the sales taxes to VAT. To implement this in a phased manner, the empowered committee consisting of finance ministers from 9 States was constituted. The committee has decided that the states should implement VAT from April 2003. It was also recognised that the best way would be to have value added tax on a wide base covering both goods and services, applied on the principle of destination. Reflecting this concern, India's then Finance Minister, Dr. M Singh, in the course of his Budget Speech for 1993-94 observed: "... *Our long-term aim should be to move to a Value Added Tax System*". However, this is well acknowledged that "*this could not be done overnight*". The reason was that, under the Indian Constitution powers of taxing commodities are shared by the Federal and the States, and it has been difficult task on achieving consensus and problems will arise in operating a VAT. What remains to be seen here is the how it is going to get affected by e-commerce. The Income Tax Department in India had set up a working group to examine the tax implications of e-commerce transactions. The group submitted its report in 2001 (July). The report recognized the fact that in Internet transactions, figures (such as total profits of the enterprise, receipts accruing or arising in India, and the total receipts of the non-resident) would be unavailable. In these situations, the requirements of section 9(1) (i) and rule 10 of the Income Tax Rules (dealing with presumptive tax provisions) would be left unfulfilled, leading to a 'dilemma of taxing of income arising due to Internet transactions.' The report concluded that the existing tax laws were inadequate to cover e-commerce transactions. The report went on to suggest that the Tax Planning and Legislation (TPL) section of the Central Board of Direct Taxes (CBDT) undertake a study on the issues arising out of taxation of e-commerce transactions. The Report also expressed concern about the distributional consequences involved with the shift from source to residence-based taxation. Especially worrying for India's tax authority was the fact that equilibrium in revenue sharing between countries of source and countries of residence was not one of the stated objectives of the OECD or the US. It stated the problems of determining residence. It opined that there was no substitute to the 'place of effective management test'. When the "place of effective management" was tough to determine after giving due consideration to a variety of factors, source-based taxation should prevail<sup>33</sup> (Central Board of Direct Taxes, 2001).

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32 A NASSCOM survey also expects e-commerce in India to grow from US\$ 27.87 million in 1998-99 to US\$ 255.3 million in 2000-2001 and be between US\$ 5.7 and 13.4 billion by 2008.

33 Central Board of Direct Taxes, 2001, at pp. 60-65

The report stated that a computer terminal, which is used to receive and send information across national boundaries, should be regarded as a PE. The same has been said of Web sites used in e-commerce. No reasons were given in support of this stand. The report also considered the imposition of a presumptive tax in the form of a fixed portion of billings, or a 'bit tax.' This approach was ultimately dismissed as being too simplistic. The report also considered homepages on Web sites. It observed that homepages are analogous to magazine advertisements. No tax implications arise from placing advertisements on the Internet under the existing laws. A view could be taken, however, that when the seller's homepage is downloaded at the user's computer, a fixed place of business is created at that physical site. If the Web page is downloaded often enough, the activity may be considered regular enough for it to be treated as a fixed place of business. However, as article 5 stands today, requirements of a place of business in physical space at a particular geographical location would not permit this interpretation. The report also considered Internet sales of software. In these cases, it noted, it would be necessary to examine whether supply of software was an isolated transaction or whether there is an element of continuity involved. This can be an indication of the presence of a business connection. However, to conform to the requirements of a business connection, there should be a real and intimate connection and commonness of interest between the trading activities carried on outside India and the trading activity carried on inside India. Mere purchases from abroad, on a principal-to-principal basis, do not establish a business connection. The report also examined the case of Indian software vendor obtaining software on the Internet from a foreign software vendor, selling the same to Indian buyers, and remitting a mutually agreed amount of the sale proceeds to the foreign vendor. In this case, since the foreign vendor in India carries out no activity, (apart from transmitting the software to India from abroad), no portion of the remittance can be brought to tax in India under section 9<sup>34</sup>.

The report also suggested the formation of an international organization to detect any transaction on the Internet. The articles on 'Mutual Agreement Procedures' and 'Exchange of Information' can also form the basis of a system of dissemination of information on Internet transactions to competent authorities in various countries. Another suggestion that was considered was the imposition of a tax on the person who gets the receipts that result in the creation of assets in the form of movable/ immovable property. The identification of the property could also be undertaken by the international organization to be set up, as suggested in the preceding paragraph. The jurisdiction to tax could be assigned to the country of the person receiving the payments. A new article could cover the sharing of tax proceeds in double taxation avoidance agreements. In the situation prevailing in a country like India, if the tax reforms were to be revenue neutral, if not yielding more revenue, and at the same time the decisions of economic agents were not to be needlessly inferred with, there is no alternative but to design a system whereby domestic consumption could be taxed comprehensively but without giving rise to the complexities and inefficiencies that mark the existing structure.

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<sup>34</sup> *Income Tax Act, 1961*

# Chapter - 8

## INTERNATIONAL INITIATIVES: CONSUMPTION TAXATION

### INTRODUCTION

How to reconcile national fiscal boundaries with the borderless world of e-commerce? One of achieving it is to have greater international co-operation. The second question is how far there had been developments in right direction and who are the major players in that action. There is a growing environment of trust and co-operation between tax authorities and the business community, which will prove useful in the drive to reach satisfactory tax solutions in e-commerce. Obviously, governments around the world will have to co-operate with each other too. Some of that co-operation is already in evidence. Following are synopses of recent responses from key global players in the area of e-commerce regulation: the United States, the European Union, the OECD, and the WTO. Generally, these responses state two common themes: (1) the need for a recognizable general governmental policy on e-commerce, and (2) the importance of the development of specific e-commerce tax policies.

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## 8.1 WTO RESPONSE

The WTO has done a substantial amount of work with regard to e-commerce. But, the crosscutting and rapidly evolving environment of e-commerce challenges the functional treatment of trade within the WTO (General Agreement on Tariffs and Trade (GATT) and General Agreement on Trade in Services (GATS)) as well as the future work program of the WTO. At the 1998 Geneva Ministerial, WTO members agreed to a temporary moratorium on customs duties for all products delivered over the Internet. A key motivation for the moratorium was the difficulty of distinguishing between the physical and electronic delivery of products purchased over the Internet and the blurring of the traditional distinction between goods and services. On the one hand, products purchased electronically but delivered physically (such as books from Amazon.com that reach their destination via DHL) would appear to be subject to existing WTO rules on trade in goods. On the other hand, a radiology scan delivered electronically would likely be a kind of service. Consider, though, software downloaded from the Internet (and which may or may not exist on a hard medium such as a CD). Is this a good or service? Should these products fall under the purview of the GATS, GATT, or neither? (Mann, 2000). To help clarify these issues, the Geneva Ministerial declaration mandated that the WTO General Council embark on a comprehensive analysis of all trade-related aspects of e-commerce. The General Council assigned the work program in parts to the Goods Council, the Services Council, the TRIPS Council, and the Trade and Development Committee. In addition to examining the treatment of products delivered via the Internet, the work program more generally considered how the WTO should approach e-commerce relative to the scope of work of other organizations like WIPO, the OECD, and regional trading groups.

One extreme possibility is to characterize all transmissions on Internet as goods with GATT discipline applied to them. Such a characterization accompanied by a ban on custom duties on the transmissions, currently in place, would amount to the WTO members committing themselves to complete free trade transactions routed by Internet. This is because national treatment and MFN status are general obligations under GATT. By accepting the GATT discipline, under national treatment, the member countries would give up their right to discriminate against Internet imports as far as domestic taxes are concerned. In addition, the ban on custom duty would bind their tariffs on Internet imports at zero (Panagariya, 2001). However, moratorium on customs duty, which was born as a result of US efforts in the Geneva Ministerial (1998), makes sense only if there is a consensus that digitised products are goods. Second, even if there were a consensus that digitised products are goods; it would be very difficult to administer customs duties on products invisible to customs officers (Mann and Knight, 2000; Cairncross, 2001)<sup>1</sup>. At the opposite extreme, abandoning both GATT and GATS and develop an entirely new discipline for Internet trade. Once again, virtually no one is advocating this position. For the search for a new discipline for e-commerce makes little sense. Internet services, which include Internet service providers and phone lines on which transmissions flow, are already subject to GATS and the Agreement on Basic Telecommunications. All electronic transmissions that flow on Internet,

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<sup>1</sup> Mann and Knight (2000) at pp 87-88; Cairncross (2001) at p 180

on the other hand, have counterparts in either goods trade or services trade. As such, the rules necessary to regulate that trade can be found in GATT or GATS. Thus, the real choice is between applying GATS to all Internet trade or GATT to that trade for which physical counterparts also exist and GATS to all other e-trade.

In my view, on balance, it makes more sense to define all electronic transmissions as services<sup>2</sup>. At one level, it may be argued that at the time Internet transmissions cross the border between two countries, they do not have a physically traded counterpart. The eventual transformation of the transmission into a good such as a book or CD does not negate the fact that at the border the transmission did not have a physically traded counterpart. Indeed, in many cases, the transmission may not be turned into the physically traded counterpart at all. For example, the recipient may continue to store it in the digital form with books read on the screen and music played directly on the computer. Nevertheless, the key advantage of adopting the across-the-board definition is that it is clean and minimizes possible disputes that may arise from countries wishing to have certain transmissions classified as intangible goods and others as services. Under a mixed definition, in any trade dispute involving Internet trade, panels will have to first decide whether the object of dispute is a good or a service to determine whether the rules of GATT or GATS are to be applied in evaluating the dispute. The adoption of the across-the-board definition automatically resolves this issue (Panagariya, 2001).

Now the question is if digitised products were services, which one of the four modes of service delivery would characterize digitised products. It is not clear whether digitised products should be construed as cross border service trade (mode 1), from the territory of the supplier to the territory of the buyer, or as consumption abroad (mode 2) in the territory of the seller. Mode 1 commitments were more restrictive than mode 2 commitments because countries wanted to encourage foreign suppliers to set up commercial presence (mode 3). Mode 2 commitments were relatively liberal because it is not easy to check one's nationals from consuming services abroad (Drake and Nicolaidis, 2000)<sup>3</sup>. If digitised products were viewed as cross-border trade, and, if governments could somehow control this trade, the illiberal commitments for cross border trade (mode 1) would restrict it. If, on the other hand, the same assumptions held for consumption abroad (mode 2), then countries may have over committed themselves in an era when they did not view digitised imports as being defined as consumption abroad. If a new mode 5 was created just to deal with digitised products within GATS, this would constraint global e-commerce, and it would be tough to draw the boundary between mode 1 and 5.

Although much has been done, several significant questions remain. The US and the EU are approaching them in different ways, and are arriving at different answers. The issues are whether to

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2 The European Union strongly asserted that 'all electronic transmissions consist of services;' and, therefore, these products should fall under the purview of GATS. Most countries, including the US, agreed that services delivered over the internet are covered by GATS, but other products are more like a good or are a hybrid between a good and a service (electronic books are a popular example). US argued that more time is needed to monitor the development of e-commerce before any final classification takes place. World Trade Organization, 'Communication from the European Communities and their Member States on the WTO Work Programme on Electronic Commerce,' 9 August 1999.

extend the moratorium, how to classify e-commerce trade, and modalities for reconstituting the work program. It is clear that the main thrust should be on how best to utilize e-commerce to promote continued liberalization of global trade, rather than spending scarce resources figuring out whether or not to liberalize it. However, that agenda making has shifted from the WTO, which was evident from paper of Walter Hellerstein (Hellerstein, 2002) submitted to the Committee on Trade and Development of the WTO. The author, did not mention the developments within the WTO. The arena for decision-making has shifted to the US and the EU, and, to deliberations within the OECD. Nevertheless, keeping with its role as overseer and arbiter of international trade, the WTO is particularly concerned with e-commerce's impact on developing countries. With the other e-commerce issues, however, the WTO appears currently to be taking a detached posture, only suggesting areas of concern for further consideration and study, waiting for member countries to develop their own policy responses before taking any firm positions of its own.

## **8.2 POLICY DIFFERENCES BETWEEN US AND EU**

Historically EU and US took different policy positions toward applying consumption taxation on e-commerce. Along a tax continuum, the US, at the federal level has been more reluctant to permit the application of consumption taxes on electronic transactions than the EU. However, the states in the US have been divided into two groups about how aggressively they want to impose consumption taxes on e-commerce, whereas the EU Member States held the position that consumption taxes should be applied on electronic transactions. A detail analysis of why EU and US took different policies stances toward levying consumption taxes on e-commerce is beyond the scope of this thesis which more of political interest rather than economic benefit. But this is beyond any argument that e-commerce presented a n unprecedented opportunity to e xamine, r adically s imply, a nd g reatly i mprove t he US states' current sales tax system<sup>4</sup>. Though appealing, exempting e-commerce from sales tax does not promote free trade. As Governor Leavitt stated, 'Free trade means level playing fields, not special advantages. The prohibitionist campaign is an effort to give an unfair competitive advantage to one group of sellers. It is protectionism cloaked as free trade.'<sup>5</sup> In addition, opposing tax on sales on the Internet does nothing to remedy the overly complicated state sales tax systems currently in place. Finally, those who oppose the taxation of Internet sales increase the appeal of their political rhetoric by characterizing the tax as a revenue protection measure when in fact it is not.

## **8.3 DEVELOPMENT WITHIN THE UNITED STATES**

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<sup>3</sup> Drake and Nicolaidis (2000) at pp 411-414

<sup>4</sup> I will discuss about the Streamline Sales tax project later in the next section.

<sup>5</sup> Governor Michael O. Leavitt, Address to the National Press Club (November 16, 1999). As cited in McKeown, Rich (2000) 'Questioning The Viability Of The Sales Tax: Can It Be Simplified To Create A Level Playing Field?', Brigham Young University Law Review, Symposium Transcripts

### 8.3.1 INTERNET TAX FREEDOM ACT

In the United States, the Congress passed the *Internet Tax Freedom Act* (ITFA) in 1998. In 1997, when state and local governments concerned with consumer migration to the Internet were moving towards legislation that would impose 'use taxes' on digitised transactions, Representative Christopher Cox (R-California) and Senator Ron Wyden (D Oregon) introduced the ITFA. The Tech law Journal described the ITFA as 'perhaps the most important issue in the 105<sup>th</sup> Congress', and many at that time believed that it banned all Internet taxes on e-commerce (Tech Law Journal Congressional Scorecard, 1999). The ITFA put a three-year moratorium of multiple or discriminatory taxes on e-commerce and taxes on Internet access fees for period of 1<sup>st</sup> October 1998 to October 21, 2001 and had been further extended till November 2003. Exceptions to this moratorium were Internet access taxes 'generally imposed and actually enforced' before October 1, 1998 (H.R. 4328 1998, 1782-1783). It also created a temporary 19 member Advisory Commission on Electronic Commerce (ACEC) 'a thorough study of Federal, State and local, and international taxation and tariff treatment of transactions using the Internet and Internet access and other comparable intrastate, interstate, or international sales activities.' Its members represented federal, state, local governments, consumers, and businesses (Noto, 1998)

On April 3, 2000, the ACEC presented to Congress the results of its 10-month study of the issues of taxes and the Internet. Although the commission was unable to generate the two-thirds majority vote required by the act to send a 'formal' recommendation to Congress on the subject of taxing electronic commerce, a simple majority of its 19 members did agree on a fairly comprehensive plan that addresses many Internet and telecommunications tax policy issues.<sup>6</sup> The proposal includes:

- A five-year exemption for digitised content downloaded from the Internet and 'their non-digitised counterparts.' This proposal would effectively exempt music, videos, books and magazines, games, and software from taxation.
- Codification of the *Quill* decision regarding nexus for use tax purposes and provision of safe-harbours that would prevent corporate affiliation, repairs, and returns from being construed as evidence of a physical presence in the state.
- Application of the physical presence test of *Quill*, extended as described above, to nexus for business activities taxes.
- A suggestion that the National Conference of Commissioners on Uniform State Laws (NCCUSL) be asked to draft a uniform sales and use tax act that would include: (a) uniform tax base definitions; (b) uniform vendor discount, (c) uniform and simple sourcing rules; (d) one sales and use tax rate per state and uniform limitations on state rate changes; (e) uniform audit procedures; (f) uniform tax returns/forms; (g) uniform electronic filing and remittance methods; (h) uniform exemption administration rules (including a database of all exempt entities); (i) a methodology for approving software that sellers may rely on to determine state sales tax rates; (j) a methodology

for maintaining revenue neutrality in overall sales and use tax collections within each state (ACEC,2000).

One of the most fundamental issues before the Commission concerned the application of state and local sales and use taxes to Internet and other remote retail sales. Sales taxes are 'consumption-type' taxes designed to generate revenue. In general, these taxes are calculated and collected by businesses at the point of sale and remitted to the appropriate taxing authorities. While the exact impact of e-commerce on sales tax revenues may be uncertain, clearly the need for substantial sales tax simplification is necessary in this emerging digital economy. In the course of the Commission's examination of the impact of e-commerce on sales and use tax collections, there was general agreement among the Commissioners that the current sales and use tax system is complex and burdensome. Most, if not all, of the Commissioners expressed the view that fundamental uniformity and simplification of the existing system are essential. The need for nationwide consistency and certainty for sellers as well as the need to alleviate the financial and logistical tax collection burdens and liability of sellers were common themes throughout discussions. Commissioners also identified issues raised by sales of digitised goods over the Internet. They discussed the challenge of determining the identity and location of the consumer of digitised goods and the need to protect consumer privacy rights. The Commission's proceedings helped widen public awareness of the issue and provided an exceptional framework for debating complex tax issues.

### **8.3.2 STREAMLINED SALES AND USE TAX AGREEMENT**

On November 12,2002 representatives of over 30 states voted to approve the Streamlined Sales and Use Tax Agreement, an agreement between states aimed at simplifying taxation for all retailers, and increasing the collection of taxes by mail-order and online companies. The Agreement will become effective when a sufficient number of individual states amend their tax laws to comply with its model tax laws. Representatives of 33 states, and the District of Columbia, voted to approve the agreement. Eventually this document could affect the way tax is collected on over \$3.5 trillion in annual retail sales in US. The Agreement, which supporters' claim will greatly reduce the tax compliance burdens of retailers, is the culmination of over two years work by the Streamlined Sales Tax Project.

The passage of the Agreement is only beginning. To be effective at least 10 states, comprising at least 20% of the total population of states with a sales tax, must become members in the Agreement. In order to do so, they must first amend their own tax laws to comply with the terms of the agreement. It takes effect after the tenth states is found in compliance, but cannot take effect before July 1<sup>st</sup> 2003<sup>7</sup>. The Agreement is between individual Member States, which are described as 'cooperating sovereigns'. It provides a mechanism through which Member states will maintain a 'cooperative, simplified system for the application and administration of sales and use taxes under the duty adopted law of each

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6 Advisory Commission on Electronic Commerce  
7 SSTUA 701

member state<sup>8</sup>. The Agreement does not invalidate, amend, or supersede any provision of state law. Instead, Member States must bring their own sales and use tax laws into compliance with the Agreement, as a condition of becoming members in the Agreement<sup>9</sup>. Only Member States are bound by the Agreement. Individual taxpayers are not directly affected. Individual taxpayers are affected only when Member States amended their own laws in order to comply with the agreement. It is intended, under the Agreement, that no person will have a course of action under the Agreement, and that no person can bring action related to a state's non-compliance with the Agreement<sup>10</sup>. To simplify the administration of sales and use tax, the agreement provides model tax rules in number areas, which all Member States must adopt. By applying a consistent set of rules, the tax compliance burden for multistate retailers is lessened.

There is probability that some people would oppose this Agreement particularly those who would be hurt by the simplification. For example, under the Agreement, each member state would provide for state level administration of sales and use tax. *This means that both state and local tax would be administered by the same state agency.* This would take away the power to administer local tax from local authorities where it currently exists. Some people will attack the agreement on Constitutional grounds. They would argue that, by agreeing to cooperate in the administration of sales tax, states are overstepping their authority and attempting to regulate interstate commerce. However, under the Agreement, as under current law, online sellers that do not have physical presence in a state cannot be compelled to collect tax, though Agreement supporters are hoping these sellers will come forward voluntarily to collect the tax. Also some supporters are hoping that simplified sales tax system will help the states in their effort to win Congressional or Supreme Court approval of the power to compel remote sellers to collect tax. Whatever may the federal system does in future of taxing remote sales this had been a step in the right direction (Hardesty, 2002).

#### 8.4 DEVELOPMENT WITHIN THE EU<sup>11</sup>

In the Lisbon European Council, meeting on March 2000, the 15 Member States agreed that concrete measures were to be taken to allow e-commerce to reach its full potential in the EU. The Council decided that this could only be achieved through the furtherance of rules that would make the regulation of e-commerce inside the EU as predictable as possible while at the same time inspire business and consumer confidence. Informally the Council approved the efforts that were already being made since 1997 to draft a proposal for a Council Directive to amend the Sixth Directive in the light of the new fiscal challenges.

In 1997 European Commission made one of the first official statements on the future of the EU's, VAT system when the Commission started to examine the tax implications of e-commerce. This approach

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8 SSTUA 1101

9 SSTUA 1102

10 SSTUA 1103

11 This Section is adopted from the paper Basu, Subhajit (2002) 'European VAT on Digital Sales' The Journal of Information, Law and Technology (JILT) 2002(3)  
website: [www.elj.warwick.ac.uk/jilt/02-3/basu.html](http://www.elj.warwick.ac.uk/jilt/02-3/basu.html)

was inspired by the fact that the Internet as a novel way to trade internationally was posing questions on whether the existing fiscal principles and mechanisms would be able to collect the potential tax revenue created by e-commerce. During 1997 the Commission launched a series of informal meetings with representatives of the 15 national tax administrations who examined the ways in which the growth of e-commerce was likely to effect the EU's VAT structure, and attempted to short-list the problems that could be encountered and the practical ways to overcome them. By April of the following year, the Directorate General for VAT and Customs (XXI) was able to produce an 'Interim Report'<sup>12</sup>. Following an review of the ways in which e-commerce was marked to influence the ways in which people and businesses buy and sell things, and therefore how they consume goods and services for purposes of VAT, the report concluded that the existing system of indirect taxation was the best way to approach the fiscal challenges of e-commerce. However, the Interim Report also pointed out that the administration would need to be mindful of the likely impact of changes in the pattern and in the volume of transactions. At this time therefore, the Commission committed itself of not introducing any new mechanisms of taxation or amending the legal base of the Sixth Directive and recommended that the existing system would be sufficient to ensure collection of taxes.

The Interim Report also outlined some of the immediate hurdles. This was in particular applied to physical goods that are purchased by private consumers over the Internet but are then delivered by traditional means. For VAT purposes, these are treated in the same way as any other form of distance sales, either in the Member State of the seller or the buyer (dependent largely on the volume of such trade carried out by the other seller). There are well established channels for taxing these transactions—goods purchased from third countries are taxed at import, exported goods are zero-rated, and intra community sales of goods are taxed under a special regime for distance sales. While the report said that no changes were necessary it however called for a simplification of the rules on the custom clearance of small volume imports and at the same time it did not exclude that as more and more people would be ordering goods from Internet stores some fine-tuning of the EU distance selling rules would become necessary. Meanwhile, the Commission had anticipated that a simplification of the customs clearance procedures could be included in the framework of the next VAT strategy drawn up by the EU.

The Interim Report further recommended that a revision of VAT rules was urgently necessary to protect the tax base for direct e-commerce transactions. The possibility that products could be delivered electronically was something unheard of when the Sixth Directive was first put into place. The Directorate General warned as early in 1998 that there is possibility of revenue loss and could give rise to serious long-term problems for tax administrations. It was decided therefore that amendments to the Sixth Directive were to be made as quickly as possible to prepare the European VAT system to the inevitable explosion of e-commerce, and particularly the possibility of new products being delivered digitally. It was proposed that the VAT legislative base be amended to take into account new principles and review the models of compliance, control, and enforcement. It also recognised that a level of

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<sup>12</sup> DG XXI, Interim Report 98/0359 of the 3rd April 1998 available at  
Website: [http://europa.eu.int/comm/dgs/taxation\\_customs/](http://europa.eu.int/comm/dgs/taxation_customs/) (Hereinafter: 'Interim Report')

concerted effort based on international collaboration was being necessary in streamlining principles, avoiding double taxation or unintentional non-taxation. Hence, to achieve international consensus European community worked a long with the OECD to provide a wide international forum bringing around the same table the major countries that both adopted a system of indirect taxation compatible with that of the EU and which are major trading partners of EU. To this end, the Commission adopted a set of guidelines<sup>13</sup> published in June 1998, drafted on the principles which regulate VAT in the EU, these guidelines gave due recognition to the need for international accord. The starting point for the achievement of this harmonisation, the guidelines suggested, was an international recognition of neutrality as the most important principle in any fiscal treatment of e-commerce.

This principle of neutrality was also included among the five principles<sup>14</sup> contained in the Taxation Framework Conditions approved by the participating Ministers in the Ottawa conference of OECD<sup>15</sup>, and during the ensuing work by the various working parties of the Committee on Fiscal Affairs and particularly the talks with representatives of business, it emerged as the most important principle. In its guidelines,<sup>16</sup> the Commission described the principle of neutrality as the basic condition that would link the trading between the EU and the rest of the world, and ensure that all electronic supplies for consumption in the Community would be subject to EU VAT while supplies to other jurisdictions would be not. This approach which in effect tried to make non-EU based suppliers charge VAT on the products delivered to the customers within the EU would eventually lie at the basis of the proposal for the Directive amending the Sixth Directive in an attempt to level the competitive advantage enjoyed by non-EU vendors over EU vendors.

The Commission's communication was considered by ECOFIN council at its meeting on 6<sup>th</sup> July 1998 which welcomed them as the basis of a consistent Community input to the forthcoming OECD Ottawa conference and the political foundation on which changes to the VAT system made necessary by e-commerce should be made. The ECOFIN summarised this political framework in three points: (i) the existing system of VAT should be used for the indirect taxation of e-commerce and new forms of taxes should be excluded. This requirement follows from the principles of neutrality and simplicity. Neutrality in this context means that the method of commerce used to effect transactions should not influence the consequences of taxation. The principle of simplicity aims at keeping the compliance burden of the tax system to a minimum. (ii) Electronic deliveries warranted a revision of the interpretation of the distinction between goods and services which is fundamental in the workings of

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13 Commission of The European Community, 'E-Commerce and Indirect Taxation', Communication to The Council of Ministers, The European Parliament and to The Economic And Social Committee (COM (98) 374) (Hereinafter: 'Guidelines')

June 1998, Website: [http://europa.eu.int/comm/dgs/taxation\\_customs/](http://europa.eu.int/comm/dgs/taxation_customs/)

14 The five principles identified in the Taxation Framework Conditions are (i) Neutrality, (ii) Efficiency, (iii) Certainty and Simplicity, (iv) Effectiveness and Fairness and (v) Flexibility, OECD (1998) 'Electronic Commerce: Taxation Framework Conditions', A report by the Committee on Fiscal Affairs, October.

15 OECD (1998) 'Electronic Commerce: Taxation Framework Conditions', A report by the Committee on Fiscal Affairs, October.

16 Supra Note 13

VAT, and recommended that products that are delivered through digital means should not be considered as goods but services through a specific provision to that effect in the Sixth Directive. Due to the lack of tangibility in case of electronic transmissions, this classification is the only way to catch these transactions for VAT purposes. By clearing up the uncertainty surrounding the interpretation of digital deliveries now, this guideline also serves the purposes of legal certainty, which is essential for reducing the risks of unforeseen tax liabilities. (iii) That the jurisdiction of the EU to charge VAT on indirect e-commerce should be limited only to those products consumed within the territory of the Union and therefore making necessary a revision of the interpretation of the principle of consumption.

The ECOFIN also recommended that effective ways for the control and enforcement of e-commerce should be explored, highlighted the need to adopt a legislative framework through which electronic invoicing would be allowed throughout the EU without the need for supplier to issue also paper invoices and simplifying as much as possible the rules with which non-EU operators have to comply, most notably the requirements of registration for VAT purposes. Finally, the ECOFIN also considered the importance of automating all the fiscal obligations of operators by enabling them to discharge them through electronic VAT declaration and accounting. The council further said that once a mechanism enabling the returns to be filed and declarations to be made electronically was in place, there should be no reason why this should be limited only to e-commerce businesses and thus simplifying the entire VAT system by modernising and computerising it.

Ottawa conference of OECD in October 1998, Taxation Framework Conditions confirmed the Commission's approach, which generally repeated the principles, which had been advocated in the EU in its first initiatives on the subject a year earlier. The Commission further recognised that answers to the questions posed by the fiscal treatment of e-commerce should be pursued in close association with the business community, who together with the national tax administrations, would be directly affected by any potential changes to the Sixth Directive. For this reason in January 1999, the Commission organised a Round Table conference in Brussels on the options available to the EU VAT system and e-commerce. The meeting provided the Commission with the ideal opportunity not only to explain to the business sector its initiatives on the issue but also to encourage comments from the participants. This initiated a process of dialogue and led to the creation of an informal contact group between representatives of the Commission and of European business, which would continue meeting regularly to assess together any developments. The willingness with which businesses participated in meetings and discussions that characterised the consultation process can easily be explained through their concern to protect their commercial interests, above all, by ensuring that any new rules that would be introduced by the EU would be clear enough to ease compliance and above all guarantee certainty.

The Commission's Taxation and Customs Union Directorate General issued a working Paper<sup>17</sup> in June of 1999, this was a significant step forward at arriving to the level of certainty sought by the business community by proposing a set of options how the principles developed since then should be implemented through legislative amendments within the framework of the EU's VAT system. This duality followed from the fact that even though Europe wishes to take advantage of the great economic opportunity brought about by e-commerce; it also has an interest in protecting the revenues and competitiveness of its Member States.<sup>18</sup> The *paper* outlined an approach that would be taken up by the Commission as one of the major concerns that should be addressed by legislative reform it also argued that since international trade was fast being dominated by the delivery of services in intangible form, the reverse charge mechanism<sup>19</sup> was not adequate to comprehensively take into account the wide array of services that with constant technological developments were capable of electronic delivery.

The efficiency of any tax system largely depends on the voluntary compliance of the taxpayers.<sup>20</sup> One of the core objectives of the VAT system therefore was to *minimization of the compliance burden*. Further to develop such administrative rules it should take account of the diversified, decentralized and evolving nature of the electronic market. For the sake of such requirements, the Commission proposed to facilitate electronic invoicing and the discharge of fiscal obligations by means of electronic VAT declarations and accounting. When voluntary compliance fails, *tax systems should be ready to enforce fiscal obligations*.<sup>21</sup> As it will be seen below, *enforceability* is the *Achilles heel* of the prospective VAT system. Enforcement causes problems owing to the difficulties in identifying suppliers and customers in general within the digital world. However, the problem is more acute with respect to foreign suppliers. On what grounds and by which means can the European system oblige third country enterprises to comply with Community rules?<sup>22</sup> The proposal of the Commission tried to find the answers to these questions.

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17 European Commission's Taxation and Customs Union Directorate General (DG XXI), 'Indirect Taxes and E-Commerce', 1201/99.

18 Commission Of The European Community, DG XXI, Interim Report on the Implications of Electronic Commerce for VAT and Customs, XXI/98/0359-EN, April 3, 1998 (Working Paper – 1998) See Guidelines

See Commission of the European Community, Harmonization of Turnover Taxes, Working Paper of see Directorate General XXI, June 8, 1999 ('Working Paper 1999')

See Commission of the European Community, Explanatory Memorandum to the Proposal for a Council Directive amending the Sixth Directive as regards the value added tax arrangements applicable to certain services supplied by electronic means (COM (2000) 349 final) June 7, 2000 ('the Explanatory Memorandum')

19 Verification of the taxable status bears outstanding importance in cases of cross-border supplies to businesses, where the Sixth Directive assigns tax liability to the business recipient of certain services under the 'reverse charge' method. The rationale behind the reverse charge or self-assessment system is the wish to ensure taxation at destination. However, application of reverse charge is merely viable in case of business recipients, who have the sufficient means to fulfil such obligation and are motivated for compliance by the right to deduct the input credits. Final consumers lack both; moreover, the lack of audit-trail would render enforcement impossible. Consumption Tax Aspects of Electronic Commerce, A Report from Working Party No. 9 on Consumption Taxes to the Committee on Fiscal Affairs, OECD, 15 (2001)

20 Tait, Alain A. (1998) at p 270.

21 Ibid

22 This question constitutes one dimension of the conflict between the US and European approaches to taxing e-commerce. Namely, the Supreme Court of the United States decided in the Quill-case that businesses are not responsible for collecting a use tax unless they have a physical

#### 8.4.1 PROPOSAL FOR A COUNCIL DIRECTIVE AMENDING THE SIXTH DIRECTIVE

The EU Commission proposed amendments to the Sixth VAT Directive addresses a very narrow field of e-commerce,<sup>23</sup> what is known as *direct e-commerce*, it focuses on the issue of cross-border supply of digitised products, with special regard to those destined to final consumers in the Community. The Proposal of 7<sup>th</sup> June 2000 was the first attempt to give a black-on-white solution to the problems, which were examined since 1997. It also put doubt on previous statements of Commission that there would be no need to effect any radical changes to the European VAT system and the e-commerce could be taxed using the same VAT platform, save some minor amendments such as the proposal itself. The explanatory memorandum<sup>24</sup> spoke in brief how e-commerce posed to change the way in which people buy and sell things, in other words the world of trade. The Commission predicted that at some point “*a full scale review of the exiting VAT*” would be necessary. June 7<sup>th</sup> Proposal failed to capture enough support and as result of which Commission placed the 7<sup>th</sup> May 2002 proposal. In the following section, I will discuss the June 7<sup>th</sup> Proposal. The basic objective that was laid down in the June Proposal also remained the same in May 2002 proposal. Hence the following discussion will provide a comprehensive outline along with some criticisms, specific issue based criticism will be provided along with May 2002 proposal.

#### 8.4.2 JUNE 7TH 2000 PROPOSAL

On June 7, 2000, the European Commission presented a proposal for a Directive to modify the rules for applying VAT to certain services supplied by electronic means as well as subscription-based and pay-per-view radio and television broadcasting. The Commission proposed<sup>25</sup> to change the EU VAT regime for e-commerce operators by proposing amendments to Sec. 9, 12, 24, 28g, and 28h of the Sixth Directive. ‘*The Commission’s intention is that the proposal should give e-commerce operators a clear framework in which to charge, collect and remit VAT on electronic deliveries*’<sup>26</sup>. The direction taken by the proposal is to (i) Clarify the provisions regulation that VAT chargeability, (ii) simplify the procedures for the collection and remittance of VAT and (iii) remove the competitive advantage enjoyed by non-EU e-commerce operators. Under current rules, goods imported into the EU are subject to import VAT, which is collected when the goods enter the EU. Non-EU sellers of goods are not required to register for or collect VAT. The lack of an obligation to register did not hinder the collection of the tax due because the VAT was collected at import and paid directly by the private customer. The importation of goods requires the same to be physically transported from outside the EU

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presence (nexus) in the customer’s home state. *Quill Corp. v. North Dakota* (91-0194) 504 U.S. 298 (1992).

23 Preamble of the Proposal, Explanatory Memorandum, at pp 11-12

24 The Explanatory Memorandum

25 European Commission, ‘Proposal for a Council Directive amending Directive 77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic mean’, 7th June 2000, 500PC0349(02).

26 Supra note 24 at p 7.

to a Member State where they would have to go through post or customs. Such shipments can presently be easily checked to determine whether the VAT has been paid or not. In the case when the VAT is still due, authorities would not release the goods until the buyer comes forward to settle the tax outstanding.

Whether a transaction should be subject to VAT or not, or at what rate such transaction should be charged is determined by processing a set of information. The determination of whether a transaction is subject to VAT, and according to what jurisdiction and rate should be easy enough to allow business themselves, although not without resource to tax professionals, to do it. For a person to be able to decide on the VAT chargeability of a transaction he must be aware of (i) The tax status of the customer, (ii) under which jurisdiction would that transaction fall and (iii) which VAT rate should apply? On the other hand for VAT purposes a supplier should know the tax status of his customer, and therefore whether he is either registered for VAT or otherwise a private consumer. Under the general VAT rules the supply of goods or services to a *VAT registered business by a supplier that is established in the same Member State* should be charged tax according to the prescribed rates while no tax would be charged by the supplier if the customer is a business registered for VAT in another Member State. In that case, the customer would be able to account for tax through the reverse charge mechanism. The above is already the case for the application of VAT to non-electronic transactions where the verification of the VAT registration number of a customer normally occurs through information made available by the national VAT authorities of the country of the supplier.

In the case of e-commerce, where the transaction would occur instantly, the supplier would need to be able to make the verification in real time and for this reason the proposal recommended that a structure should be put in place, augmented by the necessary tools and technical measures, to provide EU registered VAT numbers on-line. Clearly, the inability of the VIES system to provide online, real time verification prevents the suppliers from fully exploiting the comfort and speed offered by electronic trade and therefore potentially hampers the pursuance of such activity.<sup>27</sup> Simultaneously with confirming the tax status of the customer, his location should also be verified. With regard to business purchasers, if the verification process through the VIES system is successful; the location of the business can be inferred from the registration number.<sup>28</sup> In case of final consumers, there is no such supplementary system. With traditional circumstances, the consumer either paid on the spot or was required to let the supplier know of his address for purposes of delivery and payment. When ordering online, consumers use electronic mail for communicating with the seller, but e-mail addresses tell little about the real, physical residence of its user<sup>29</sup>. The most evident means of finding out their location is to ask the customers to self-declare this information.<sup>30</sup> However, unless underlining this practice with reliable verification buyers might feel tempted by the anonymity of online trade to disclose

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27 Ibid

28 subsection (d) section (1) of Article 22 of the Sixth Directive.

29 Working Paper - 1998,

Eriksen, Nils and Hulsebos, Kevin (2001)

30 Consumption Tax Aspects of Electronic Commerce, A Report from Working Party No. 9 on Consumption Taxes to the Committee on Fiscal Affairs, OECD, 15 (2001) at p 13.

falsehoods.<sup>31</sup> Despite the diverse efforts to solve this problem, there is still no reliable and feasible means of identifying and locating consumers in lack of voluntary compliance.<sup>32</sup> For the time being suppliers might verify disclosed data by using the credit card information requested from the purchaser previous to the conclusion of the contract.<sup>33</sup> They might also rely on the currency of payment in determining the taxing jurisdiction.<sup>34</sup> Evidently, neither of these examples is a dyed-in-the-wool solution.<sup>35</sup> Moreover the Commission also hoped it could rely on the modernisation of the VAT Information Exchange System (VIES).<sup>36</sup>

The proposal had been subject of severe criticism by non-Europeans who would have to collect VAT on sales to customers in the EU and remit the tax to a VAT authority in the Member State of registration. The majority of critics fare from the US. Ken Wasch, president of the American Software and Information Industry Association, considered a notable lobby in the US Congress, was reported to have said that, *'US vendors should not be tax collectors for European governments. It is also doubtful, under public international law, whether the EU has any authority to impose such a legal obligation on US entities'*<sup>37</sup>. It also appears that on-line taxes for downloaded items would be higher than the taxes, which were being applied to the same products when these are delivered through traditional ways. During the first week of July 2000, an American delegation led by Under-Secretary of Commerce Robert LaRussa was in Brussels for a series of meetings with Commission officials on how taxation and data protection were being effected by e-commerce. Speaking after one of the meetings LaRussa said *'we need to set up some kind of process where the US and the EU with our business communities can address these issues. There are peculiar US-EU issues, and you really do need an early warning system or you are going to address them too late'*<sup>38</sup>.

The European Commissioner for Taxation, Frits Bolkestein acknowledged that although VAT revenue losses because of business-to-consumers transactions were still small, but they were bound to grow and the sooner amendments were in place the better. Bolkestein described the present situation and the need for change thus: *'Today European producers of digital products, such as computer games and software, are at a competitive disadvantage compared with non-European producers because they*

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31 By disclosing false information as to their location, consumers can save significant VAT costs because of the differences in the VAT rates of the Member States and third countries.

32 OECD (2000) Technology Technical Advisory Group (TAG), 'Report on Tax and e-Commerce', December 2000. Report on the technological questions of tax collection, The conclusion of the Report is that work should be continued in the field of defining reliable technology for jurisdictional identification.

33 Supra note 24 at p 8.

34 Ibid.

35 According to the report of the Technology TAG of the OECD credit cards are likely to remain the dominant form of payment in the majority of countries for consumer transactions over the Internet. However credit cards are not reliable sources of data on consumer jurisdiction. While the concept of matching a credit card number to the country of residence was originally thought to have promise, further investigation demonstrated that there was no numerical BIN correlation to geography. Technology TAG Report, supra note 32.

36 DN IP/02/864 'VAT: New Commission On-Line Validation Service Saves Time And Costs For Businesses', Brussels, 14th June 2002

37 Ibid.

38 Ibid.

*have to apply VAT to their products within Europe. US competitors, by contrast, can export to Europe free of VAT. Similarly, European exporters to the US are now obliged to pay European VAT, whereas US producers are not faced with the same obligation. I propose to put European producers of digital products on an equal footing with Japanese competitors and US by applying VAT to digital imports into the EU and exempting digital exports from the EU. This would create a global level playing field for European and non-European companies'. The proposal sought to achieve this 'global level playing-field', where, however the US businesses would be unwilling to play.*

However, for Hardesty<sup>39</sup> one of the critics to the proposal, the EU disregarded one of the fundamental conclusions of the OECD conference. The participating Ministers at the conference had agreed that for solutions on the indirect taxation of e-commerce to be truly effective these must be the result of an international consensus. He felt that Commission went foul of this agreement and pursued its own individual solutions without waiting for what might be internationally acceptable avenues of the indirect taxation of e-commerce. The most controversial point that had been criticised in the proposal was the suggested introduction of a new single-place registration for VAT. This would have enabled the companies to apply for a VAT registration under one of the 15 national tax authorities and be able to trade with customers in the entire Community. Since the registration would have the effect of creating a place of establishment in the country of registration, all transaction of that company would be taxed according to the rates applicable in that tax jurisdiction. It is understandable how companies might prefer seeking registration in countries such as Luxembourg, which apply a 15 percent VAT rate instead of in countries with a higher rate, of up to 25 percent such as Sweden and Denmark. It is also understandable why countries such as Sweden and Denmark raised opposition to the amendments as they predicted a plummeting of their VAT revenues from tech-companies. Not only would VAT revenues decrease but the amendments would create an unfavourable situation also for the traditional brick-and-mortar<sup>40</sup> as these businesses would be selling their products at a price which could be at least 10 percent more expensive than on-line retailers simply because the latter have a VAT registration in another Member State with lower VAT rates. On these grounds, Snell<sup>41</sup> had criticised the proposal as running counter to the principles of neutrality and discrimination, which had earlier been identified by the ECOFIN council, and later also by the OECD, as two of the pillars on which any future taxation of e-commerce should be constructed. Snel further argued that the success of ideas such as a single point registration would depend on the willingness of operators to comply with such regulations. The only way to bring back an equilibrium between traditional retailers in high VAT Member States and the on-line competitors would be to apply the same lower VAT rates that apply for those type of services delivered by electronic means to services of the same class delivered off-line by the brick-and-mortar stores in the country with high VAT rates. However, such a task would be monumental and would be defying the Commission's philosophy that e-commerce should be taxed using the existing VAT platform. This is perhaps one of the first instances which confirm the Commission's concern that sooner or later the indirect taxation of e-commerce would call for a wider revision of the existing VAT

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39 Hardestey, David (2000), 'Europe Proposes New Taxes on Non-EU Sellers',  
40 Snel, Jan L.N. (2000)

system. In late November 2000 meeting the ECOFIN council recommended to the Commission to rework the proposals and present an amended version. Shortly after the ECOFIN meeting, on the 28<sup>th</sup> November 2000 a detailed report on the proposal drawn up by the European Parliament's Committee on Economic and Monetary Affairs chaired by Jose' Manuel Garcia-Margallo y Marfil was tabled to Parliament<sup>42</sup>. On The 14th December 2001, the Parliament voted to endorse the report as its official opinion suggesting a series of amendments to the Commission's proposal. In practice, this had the effect that the proposal was blocked and although not formally withdrawn, shelved for the moment.

The parliament stipulated that in order to ensure a fair sharing of VAT revenues resulting from transactions between non-EU suppliers registered in one Member State and non-taxable persons in another Member State, a system of refunds between Member States should be introduced. The Parliament further recommended that a structure should be created to provide for permanent monitoring by the Commission of the state of play as regards the implementation of the proposal in the Member States to ensure no distortion of the market. The original Commission proposal foresees that non-EU suppliers with annual sales above EUR 100,000 operating in the EU will have to register in at least one Member State, which would then be the tax jurisdiction responsible for applying the tax. The Parliament felt that to counter the risk, already mentioned above, of companies choosing to register in a low tax country such as Luxembourg, the Commission should draft another proposal to address the question of VAT revenue distribution among Member States. Moreover, the parliament proposed the threshold for registration be lowered from EUR 100,000 to EUR 40,000. In the *explanatory statement* to the report the Committee on Economic and Monetary Affairs also spoke about the future convergence between Internet and mobile phone technology. The Committee outlined its position clearly concerning this and dismissed any problems because of a fundamental distinction, which was illustrated by means of an example. The report said that where a customer being able to download information through a mobile phone, the charge for connection and airtime would fall under the heading of telecommunications whilst the charge for the information would fall under the heading of e-commerce.

The Parliament's opinion broadly supported the Commission proposal in spite of some shortcomings. The report suggested that these shortcomings mainly result from uncertainties on future developments and advised that these should be overcome in time before entry into force of the proposed Directive. 'The creation of a level playing field in electronic services is a matter of urgency, but it is essential that a system of distribution of tax revenues be put in place to compensate the advantage of those Member

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41 Ibid

42 European Parliament, 'Report on the proposal for a European Parliament and Council regulation amending regulation (EEC) No 218/92 on administrative cooperation in the field of indirect taxation (VAT) (COM(2000) 349 – C5-0298/2000 – 2000/0147(COD)) and the proposal for a Council directive amending directive 77/388 EEC as regards the value added tax arrangements applicable to certain services supplied by electronic means (COM(2000) 349 – C5-0467/2000 – 2000/0148(CNS))', 28th November 2000, Committee on Economic and Monetary Affairs, Manuel Garcia-Margallo y Marfil.

States with the lowest VAT rates<sup>43</sup>. Moreover, Parliament defended the proposal against criticism that it might be pre-empting the work that was still being undertaken by the OECD. The Committee mentioned how the main opposition to the proposal came from across the Atlantic with the intention of preserving the competitive advantage that American companies currently enjoy. This advantage was further strengthened by the US Congress's approval to extend the moratorium on the taxation of electronic services at least until 2006.

While drafting, its report the Committee sought the assistance of the Parliament's Committee on Industry, External Trade, Research, and Energy chaired by Carlos Westendorp y Cabeza and the Committee on Legal Affairs and the Internal Market chaired by Ana Palacio Vallelersundi. In its opinion the Committee on Legal Affairs and the Internal Market recommended that Parliament should request the Commission to withdraw its proposal for a directive until such time as (i) a thorough review has been carried out on the VAT charged on goods and services supplied by non-electronic means, (ii) the ongoing discussions in the OECD and other international forum have been brought to a conclusion and (iii) a complete package of measures can be proposed. Finally, during the 5<sup>th</sup> June 2001 meeting of the ECOFIN council the British Finance Minister made known that his country would not support the proposal despite the fact that the other 14 Member States expressed their willingness for plans to implement the proposal to proceed. However UK's blocking of the proposal led to the formulation of May 2002 proposal.

#### **8.4.3 VERIFICATION OF VAT NUMBERS FOR ELECTRONIC SUPPLIES**

The proposal of June 2000, brought attention to the fact that the present regulation of the confirmation of the validity of VAT registration number of a person by the Member State needed to be changed because this would not allow national VAT authorities to give confirmation of the validity of a customer's VAT identification number to a person supplying services by electronic mean. The procedure for the verification of VAT numbers is controlled through Sec. 6 of Regulation (EEC) No 218/92, which however limits the confirmation only to 'persons involved in the intra-Community supplies of goods or of services'. The proposal stressed that the confirmation of validity of VAT identification numbers by electronic means was one of the ways through which trade could be facilitated and therefore described its plans to amend the legal base to make such thing possible.

On June 14, 2002, the Commission introduced the on-line validation service<sup>44</sup>. The on-line service, which any member of the public can now access free of charge, allows checking of the databases of VAT registration numbers which each Member State maintains as part of the VIES. The database of VAT identification numbers is only one aspect of the VIES. Members of the public logging on to the site will not be able to see any of the other VIES information which is used by Member States' taxation authorities for VAT control purposes and which should, in the interests of taxpayer confidentiality,

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43 Ibid

44 Supra note 36

remain reserved for the use of taxation authorities only. Under the current VAT system, all intra-EU supplies between traders subject to VAT are exempted from VAT in the country of sale, the tax being declared at destination by the receiving trader. Normally the customer provides his VAT identification number to the supplier when he orders the goods. But it is the responsibility of the supplier to confirm that his customer is indeed VAT registered in another Member State before he sends the goods free of VAT. Otherwise, the supplier may be obliged to pay the VAT himself. Up to now, a supplier wishing to confirm the validity of the VAT identification number provided by its customer generally had to contact its own tax administration which would check the VIES and confirm that the number quoted was valid. By cutting out the intermediary, this new service speeds up this verification procedure, thus saving time and money for both businesses and tax administrations. The overall aim is to facilitate legitimate commercial transactions within the Internal Market while improving controls against fraud<sup>45</sup>.

#### 8.4.4 MAY 2002 PROPOSAL (COUNCIL DIRECTIVE 2002/38/EC)

On May 7<sup>th</sup> 2002, the European Council adopted the Directive 2002/38/EC and Regulation No. 792/2002<sup>46</sup>. The new directive will take into effect on July 1<sup>st</sup> 2003, and shall remain in effect for three years, after which time it may be extended or revised<sup>47</sup>. By the adoption of this directive digital service providers located outside of the EU would be required to register with European tax authorities by July 2003 and have to collect VAT on sales of digitally delivered products. While the rules do, indeed, place new burdens on some foreign firms, European Commissioner for Taxation Frits Bolkestein believes that ultimately, everyone's interest will be served by the legislation. *"I welcome the decision of the council to adopt these rules on applying VAT to digital products. They will remove the serious competitive handicap which EU firms currently face in comparison with non-EU suppliers of digital services, both when exporting to world markets and when selling to European consumers,"*<sup>48</sup> said Bolkestein. The Directive applied to electronically delivered services as well as radio and television broadcasting services<sup>49</sup>. The first category included digital products that are distributed over the Internet such as software. The EU treats all products that are distributed electronically as services. An annex to the proposed legislation sets out an illustrative list of the type of services that are targeted by the new framework: (i) Web site supply, web hosting, distance maintenance of programs and equipment, (ii) supply of software and updating thereof, (iii) supply of images, text, information and making databases available, (iv) supply of music, films and games, including games of chance and gambling games, and of political, cultural, artistic, sporting, scientific and entertainment broadcasts and events (v) supply of distant teaching. The Proposal contained two separate sets of provisions. The re-definition of the place-of-supply rules for electronic deliveries and the amendment of connected

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45 The online service can be accessed at the following address: <http://europa.eu.int/vies>

46 Full text of the Directive is available at [http://europe.eu.int/comm/taxation\\_customs/whatsnew.htm](http://europe.eu.int/comm/taxation_customs/whatsnew.htm)

47 Taxation and Customs Union, VAT on electronic commerce (June 3, 2002)  
Website: [http://europa.eu.int/comm/taxation\\_customs/taxation/ecommerce/vat\\_en.htm](http://europa.eu.int/comm/taxation_customs/taxation/ecommerce/vat_en.htm)

48 Reuters (2002) 'Europe Approves Net Tax Law', May 7  
Website: [www.wired.com/news/print/0,1294,52351,00.html](http://www.wired.com/news/print/0,1294,52351,00.html)

49 Hardesty, David (2002) European VAT on Digital Sales, March 3  
Website: [www.ecommercetax.com/doc/030302.htm](http://www.ecommercetax.com/doc/030302.htm)

administrative provisions necessary for the implementation of the redefined rules along with that a set of provisions under a special scheme to facilitate the compliance with fiscal obligations by operators providing electronically supplied services, who were neither established nor required to be identified for tax purposes within the Community form the heart of the Proposal. The other key point of the document was the set of provisions facilitating the discharge of VAT obligations by electronic means.

The Proposal sets forth two distinct places of supply for digital deliveries in accordance with the varying tax status and location of the recipient. The first place-of-supply rule determined the place of transactions to final consumers within the Community. It deems the location of the supplier's business or fixed establishment as the place-of-supply. This resulted in the practical extension of the general place-of-supply rule of the Sixth Directive to business-to-consumer digital transmissions.

Sub-paragraph 1(b) of the Directive proposes that:

(1) In Article 9(2), the following point (f) is added:

*“(f)...the place where services referred to in the last indent of subparagraph (e) are supplied; when performed for non-taxable persons who are established, have their permanent address or usually reside in a Member State, by a taxable person who has established his business or has a fixed establishment from which the service is supplied outside the Community or, in the absence of such a place of business or fixed establishment, has his permanent address or usually resides outside the Community, shall be the place where the non-taxable person is established, has his permanent address or usually resides.”*

While if the customer is located outside the Community by a business established in the EU that transaction would not fall under the tax jurisdiction of any Member State and would thus not be subject to VAT. Sec. 9 (3) enabled EU members to implement special tax rules to avoid ‘double-taxation, non-taxation or the distortion of competition’<sup>50</sup>. In practice this section would allow Member States to treat the place of supply that under Sec. 9 (2) would fall within the territory of a member country as being situated outside the Community ‘where the effective use and enjoyment of the services take place outside the Community’ and treat the place of supply that would normally fall outside the Community as actually being within the Member State ‘where the effective use and enjoyment of the services take place within the territory of the country’. The place of supply in the case of a transaction between a EU operator and a taxable person inside another Member State would be deemed the country where the recipient to the transaction was established. This envisages business-to-business transactions because the supply would be made to a taxable person and not to a private consumer. If on the other hand, the recipient of such a transaction was a private individual, but also a taxable person located in the same Member State of the supplier, the place of supply would now be the place where the supplier was located. Article 9, paragraph 4 is amended as follows: ‘In the case of telecommunications services and radio and television broadcasting services referred to in paragraph 2 (e) when performed for non-taxable persons who are established, have their permanent address or usually reside in a Member State, by a taxable person who has established his business or has a fixed establishment from which the

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50 Lambert, Howard (1998)

service is supplied outside the Community, or in the absence of such a place of business or fixed establishment, has his permanent address or usually resides outside the Community, Member States shall make use of paragraph 3 (b).’

By means of the new Sec. 9 (4) EU members could change the determination of the place of supply by virtue of Sec. 9 (3b) in the case of services to non-taxable persons in the EU by non-EU ISPs when such services are ‘effectively used or enjoyed’ in Community territory. Sec. 9 (3b) however can only be applied in the case when the services were supplied to ‘non-taxable persons established’<sup>51</sup> and not necessarily to EU residents only. This presents a much wider net for VAT taxation including non-Europeans using or enjoying ISP services of non-EU providers while passing through Community territory. It was argued that this could potentially have double-taxation implications<sup>52</sup>. In practice, therefore this allowed Member States to tax intangible services supplied from non-EU Member States to non-taxable customers using or enjoying such services within their country. The Commission proposed to amend the basic rule of the Directive to allow the place of supply for the supply of such services, not to the place where the services are physically carried out, but to the place where the customer either (i) has established his business, or (ii) has his or one of his fixed establishments to where the given service is actually supplied on in the absence of either (i) or (ii), where the customer (iii) has his permanent address or usually resides. There would be no tax to collect on free downloads, free information or free access to the Internet as VAT is not generally a consideration when no charge is made. The Commission also pointed out in an accompanying note to its original proposal that nothing will change in respect of services where the Internet was only used as a channel of communication between the supplier and the customer.

The Proposal added Article 26c for non-established taxable persons supplying electronic services to non-taxable persons; the article provided definitions<sup>53</sup> and Special scheme for services supplied electronically. The proposal permitted a non-established taxable person supplying electronic services to a non-taxable person who was established or had his permanent address or usually resides in a Member State, to use the special scheme in accordance with the provisions laid down in the proposal. Non-EU suppliers were allowed to register in a single member state under the ‘special scheme,’ but they would have to be able to account for VAT in all of the EU member states in which they had ‘final’ consumers

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51 Sec. 9 (4) Sixth VAT Directive

52 Lejeune Ine, Vanham Bart, Verlinden Isabelle, and Verbeken Alain (1998) at p 4.

53 For the purposes of this Article:

*“Non-established taxable person” means a taxable person who neither has established his business nor has a fixed establishment within the territory of the Community and who is not otherwise required to be identified for tax purposes under Article 22.*

*“Electronic services” and “services supplied electronically” means those services referred to in the last indent of Article 9 (2) (e).*

*“Member State of identification” means the Member State which the non-established taxable person chooses to contact to state when his activity as a taxable person within the territory of the Community commences in accordance with the provisions of this Article.*

*“Member State of consumption” means the Member State in which the supply of the electronic services is deemed to take place according to Article 9 (2) (f).*

*“Value added tax return” means the statement containing the information necessary to establish the amount of tax that has become chargeable in each Member State.*

and further they would be required to levy VAT on those transactions with EU consumers if their revenues exceed a certain threshold amount.<sup>54</sup> In addition, tax administrators would provide operators with the means to distinguish easily the status of their customers (whether the customer is a VAT registered business or a private customer), and this would provide a means whereby any supplier acting in good faith would be able to determine whether or not a transaction should be charged with VAT. In order to facilitate the introduction of the new system, non-EU suppliers would be offered a simplified online registration and compliance mechanism that would allow them to fulfil their VAT duties without establishing a physical presence or 'fiscal representative' within the EU.<sup>55</sup> However, they must register with the chosen authority by providing information including name, postal and electronic addresses, web sites, national tax number and a statement that the company was not already identified for VAT purposes in the EU. The chosen tax authority would then provide the supplier with a dedicated number by email after which the supplier must submit a quarterly VAT return that includes details on the total value of sales and tax collected in each Member State. The supplier then have to remit tax collected to the tax authority that is then responsible for reallocating the VAT revenues among the other member state.

The application of VAT for electronic services supplied from one member state to consumers in another member state within the EU would be charged at the applicable rate in the member state where the supplier is registered<sup>56</sup>. For Non-EU suppliers the directive, in its current form, does not address the issue of tax rates specifically, but the Commission would undertake a general review of all aspects of these tax rates shortly as part of its quest to modernize VAT. It is clear that a 'standard' tax rate will be established for each country within the EU, and non-EU suppliers will levy VAT according to the 'standard' tax rate of the Member State within which they are registered. Under the scheme for supplies made to third countries VAT would be levied at a rate applicable in the Member State where the customer is a resident, and revenue will be re-allocated to that state after a purchase is made. The suppliers would also have to make tax records available to member state of where they register and those member state where their consumers reside. They should keep such records for ten years after the sale. Member States have agreed that this system should be applied for three years following implementation of the Directive and then be extended or revised. According to the European Commission: *"the single registration model offers a streamlined set of obligations, which can be easily completed, online without the need for a fiscal representative or for any physical presence. This special registration scheme will be easier to operate and more business friendly than rules for non-resident businesses generally."*<sup>57</sup>

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<sup>54</sup> The initial proposal contained a 'minimum turnover threshold' of Euro 100,000. At present, it is not clear whether this threshold will be dropped entirely so that a non-EU supplier would have to register with a EU member state even though there are only occasional sales to EU consumers.

<sup>55</sup> Art. 26c VAT Directive as amended.

<sup>56</sup> This is applicable so long the seller's sales do not exceed the 'distance selling' thresholds defined for each country. Thus, taxation at the place of supply would remain in effect for all member states with the EU. For example a UK Company A, selling software and delivering it over Internet to consumer B in Germany will be charged VAT at the rate applicable in UK.

<sup>57</sup> Taxation and Customs Union, 'VAT on electronic commerce' (June 3, 2002)

Website: [http://europa.eu.int/comm/taxation\\_customs/taxation/ecommerce/vat\\_en.htm](http://europa.eu.int/comm/taxation_customs/taxation/ecommerce/vat_en.htm)

#### 8.4.5 CRITICISM AND DEFENCE

The proposal had been subject of severe criticism by non-Europeans who will have to collect VAT on sales to customers in the EU and remit the tax to a VAT authority in the Member State of registration. As has already been mentioned earlier the majority of critics fare from the US. While this proposal sounds unassuming at first, there are several potential concerns. Since VAT rates differ according to EU member states, the accounting could become a bit tricky. The standard VAT rates currently range between 15% in Luxembourg to 25% in Denmark or Sweden. Thus, any non-EU firm providing services to EU residents must keep track of their customers' locations in order to properly assign taxes. Thus, if a non-EU operator decides to register in Great Britain and makes sales to individuals in France, Germany, and Sweden, the operator will need to know that the rates to be applied at the customer location are 19.6 percent, 16% and 25%, respectively. Further it also means that a book delivered online will subject to the standard tax rate while, the same book delivered in physical form may be subject to a lesser rate, or even a zero rate<sup>58</sup>. It is unclear whether this discrepancy would be remedied. If no steps are taken to remedy it, a situation may arise in which the rate applicable to certain electronic media will differ greatly from the rate applicable to the same product when it is physically delivered<sup>59</sup>. In this simple example, a single product yields three possible tax rates depending on the form and geography of the transaction—hardly the OECD goal of “neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility.”

The problem, as the US sees it, is that while EU companies charge tax based on where their headquarters is located, Non- EU companies would be required to charge tax based on where the buyer lives. That means European companies could charge a flat tax rate for all purchases made by European customers, while U.S. and other non-EU companies would have to determine where each buyer resides before calculating tax. Such a process would place a significant administrative and technological burden on U.S. e-tailers. A letter from the U.S. Council for International Business to Commissioner Bolkestein on February 7 2002 effectively summaries the concerns expressed on behalf of businesses:

- *Proving a customer's location is difficult and may result in greater business costs for businesses;*
- *Services are not being treated equally to goods since they are standard-rated, and, in many jurisdictions, the equivalent goods enjoy a reduction in the applicable rate;*

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58 While one objective of the directive is to apply the tax rate, equally to electronic and traditional media for directly equivalent products, reduced or "zero" rates are currently in effect printed materials such as books, newspapers, and periodicals. (Taxation and Customs Union, *VAT on electronic commerce* (June 3, 2002)).

Website: [http://europa.eu.int/comm/taxation\\_customs/taxation/ecommerce/vat\\_en.htm](http://europa.eu.int/comm/taxation_customs/taxation/ecommerce/vat_en.htm)

59 For example: Consumer A purchases a book online. It is subject to the 'standard rate' VAT depending upon his country of residence. Consumer B purchases the same book, and it is delivered in physical form. It may be subject to a lesser rate, or even a "zero" rate VAT.

- *Rate discrimination results from the fact that non-EU operators' tax burdens will be greater than that of EU operators who can charge a lower rate of VAT to EU customers if they are tax-registered in a low-tax jurisdiction (such as Luxembourg);*
- *Non-EU operators will face administrative burdens that are not sufficiently spelled out yet and may result in significant costs.*

The proposal could be 'a significant problem' for U.S. and other Non- EU e-trailers, Gartner analyst French Caldwell told the E-Commerce Times. It also could cause international conflict. Gartner previously has predicted that differences between EU and U.S. tax laws will become a major source of friction in international trade by 2003. In a report released by the research firm said, 'The EU's decision to move forward with its proposals raises the probability.' The Bush administration has 'serious concerns' about the proposal and indicated that the plan may violate existing treaties and rules set out by the WTO. U.S. Deputy Treasury Secretary Kenneth Dam called for 'further efforts to achieve a more global consensus that reflects a consideration of all the issues raised.' He pointed to current discussions on e-commerce tax issues being held at the OECD. He further added 'the proposal may potentially be inconsistent with international trade obligations in the WTO, in particular the commitment to accord national treatment to foreign goods and services'. The concept of one set of countries imposing a consumption tax regime on other nations is perhaps most troublesome of all. Unilateral proposals such as this may encourage others to take unilateral measures, rather than waiting for the global consensus that can be developed through a deliberative and inclusive process, such as the OECD's, 'Hardesty'<sup>60</sup> expressed similar concern that the unilateral impetus in the EU to tax electronically delivered products might trigger a world-wide reaction with many countries following on the steps of the Commission and enacting laws that will allow them to levy indirect taxes on all electronic deliveries that are finally consumed within their territory, irrelevantly of their country of origin. This would make e-businesses wrestle with tens of different VAT regimes worldwide and the burdens of compliance would be so immense that non-compliance would be the order of the day. The EU argues, however, that the new directives simply removes a competitive handicap by not levying the VAT outside the EU and by subjecting non-EU suppliers to the same VAT rules as EU suppliers when providing electronic services to EU customers<sup>61</sup>.

Caldwell on the other hand pointed out that even if the policy were approved, it would be unenforceable, because it will be impossible to determine whether a EU consumer has downloaded digital goods from a server based outside the EU. 'And how are you going to charge VAT on Web services? That is the next thing,' Caldwell added. There may even be legal trouble. The U.S. Supreme Court has ruled that companies cannot be forced to collect taxes on interstate sales when they do not have a physical presence in the consumer's state. According to the Gartner report, if that ruling is extends to international sales, U.S. companies could be legally barred from collecting value-added tax on behalf of EU countries. In the end, the EU's proposed policy may come back to haunt it. "The bigger problem is not for the U.S. companies, it's a problem for EU companies potentially locked out of the U.S. market if the U.S. decides to retaliate." Further, this would likely to add to a series of

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60 Hardesty, David (2000) 'EU Continues Efforts to Tax Digital Products'

61 Supra note 57

disagreements between the US and the EU over trade, including the dispute over new US steel import duties<sup>62</sup>.

The proposal has not provided a comprehensive definition of what digital goods and services are covered. The list seems to be unsatisfactory in respect of the novel types of service as well.<sup>63</sup> Due to dynamic evolution of the Internet and e-commerce, there are already some services, which would fall outside the scope of subsection (2e).<sup>64</sup> The taxation of these services, therefore, would also happen according to the general place-of-supply rule. The next issue of concern is the over-complication of the place-of-supply rules that would follow from the adoption of the proposed amendments to Article 9 of the Sixth Directive. Further more the proposal is salient on the issue of how can the consumer's jurisdiction be accurately identified? To assess which Member State rate is applicable to the sale the Non-EU suppliers are going to have to be able to verify their customers' identity (business or final consumer) and jurisdiction in a real-time, on-line environment. Many companies have stressed that the technology is not yet available to do achieve this with 100% accuracy. The compliance regime for non-EU suppliers will be more onerous than their EU based counterparts. The US Treasury has argued that while a European company will be able to charge the same tax rate to every European customer, U.S. businesses will have to calculate the tax rate for each European customer who buys a download, based on the country they live in. Industry groups argue the new directive will cost large companies business and make it difficult for smaller firms to sell digital products in Europe.<sup>65</sup> The EU has argued that the special scheme is its best effort at lightening the compliance regime. It should be noted that the process of registration for non-EU suppliers applies only to 'a non-established taxable person', and not to anyone who is a ready established or has a fixed establishment for VAT purposes in any EU state. Some businesses may find it advantageous to make sure their activities are within the new registration regime, though others may find it an advantage to create an establishment in the EU and account for VAT under the existing regime. The preferred course of action will depend on the individual circumstances of each business.

Hardesty (2000) also highlighted another shortcoming in the proposal. In its explanatory memorandum to the June 2000 proposal the Commission briefly explained the ways in which it was planning to ensure compliance to the suggested amendments. The key to the EU's enforcement of these new rules is online identification of consumers. As of now, technology would not allow the online seller to verify the location of a consumer or whether the consumer is VAT registered. The directive assumes that this technology would become available, but if it is not, the entire directive becomes unenforceable. The proposal itself is absolutely silent on how compliance is to be ensured and therefore leads one to deduce that the mechanisms for compliance would be constructed on those already used for traditional

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62 Reuters (2002) *EU Taxes U.S. E-Commerce*, May 6  
Website: <http://www.wired.com/news/print/0,1294,52325,00.html>

63 It can generally be stated that the list-approach is flawed with respect to electronic transactions considering the rapid development of technology offering newer and newer opportunities for e-commerce transactions. See Eriksen and Hulsebos, *Electronic Commerce and VAT*, Taxation Comment

64 Such as, e.g., *co-location services* and *registration of domain names* see *ibid.*

commerce. However, the intangible nature of e-commerce gives rise to new problems of compliance peculiar to this new way of buying and selling things electronically. The proposal provides no detail as to how the EU national VAT authorities will be able to trace non-compliant businesses, irrelevantly if these are operating from inside or outside the Community. Hardesty however predicted that the EU competitors of offending non-EU companies would have an interest in reporting them and tip tax authorities on where to look for non-compliance. This is not a practical solution that can be offering any degree of predictability. Even if the national VAT authorities, following tip-offs or some other system, identify non-EU companies which are not compliant with the requirements of the suggested amendments, there would be another problem on enforcement and particularly in collecting the unpaid VAT due. Once again, although the explanatory memorandum hints at what might be the tools used for the enforcement of VAT rules on non-EU sellers, the proposal itself contains nothing on the matter. The Commission suggested that non-EU companies would have an interest in collecting VAT on sale to EU customers because the EU framework would be already protecting their intellectual property rights within Community territory. In other words, this is a form of give and take situation. Nevertheless, give and take situations are not law and it is not unheard of how people with an interest to make a profit take and much as they can and do not give. Various other solutions have been suggested, although not by the Commission itself.

<b>Buyer</b>	<b>Type</b>	<b>What Happens</b>
<b>EU</b>	<b>Consumer</b>	The seller collects the VAT according to his own country rules.
<b>EU</b>	<b>Business</b>	The buyer pays the service to the seller without VAT. The buyer must declare and pay the corresponding VAT according to his own country rules. The seller does not collect and VAT.
<b>Non-EU</b>	<b>Consumer</b>	No VAT is charged
<b>Non-EU</b>	<b>Business</b>	No VAT is charged

**Table 8.1: Summary for the European Union Services Seller**

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<b>Buyer</b>	<b>Type</b>	<b>What Happens</b>
<b>EU</b>	<b>Consumer</b>	The seller collects the VAT according to <b>Buyer's country rules</b> .
<b>EU</b>	<b>Business</b>	The buyer should self impose the rules of his own country. He pays the service without VAT but must declare and pay the corresponding VAT amount according to his won country rules.
<b>Non-EU</b>	<b>Consumer</b>	No VAT is charged
<b>Non-EU</b>	<b>Business</b>	No VAT is charged

**Table 8.2: Summary for the Non-European Union Services Seller**

<b>Buyer</b>	<b>Type</b>	<b>What Happens</b>
<b>EU</b>	<b>Consumer</b>	The buyer pays the VAT according to the seller's country rules. The VAT collected by the seller is sent to the Fiscal Authority of the seller.
<b>EU</b>	<b>Business</b>	The buyer should self impose the rules of his own country. No VAT is paid to the seller but it is collected when it is imported (at the Customs of the Buyer). The VAT amount paid is calculated according to the buyer's country rules
<b>Non-EU</b>	<b>Consumer</b>	No VAT is charged
<b>Non-EU</b>	<b>Business</b>	No VAT is charged

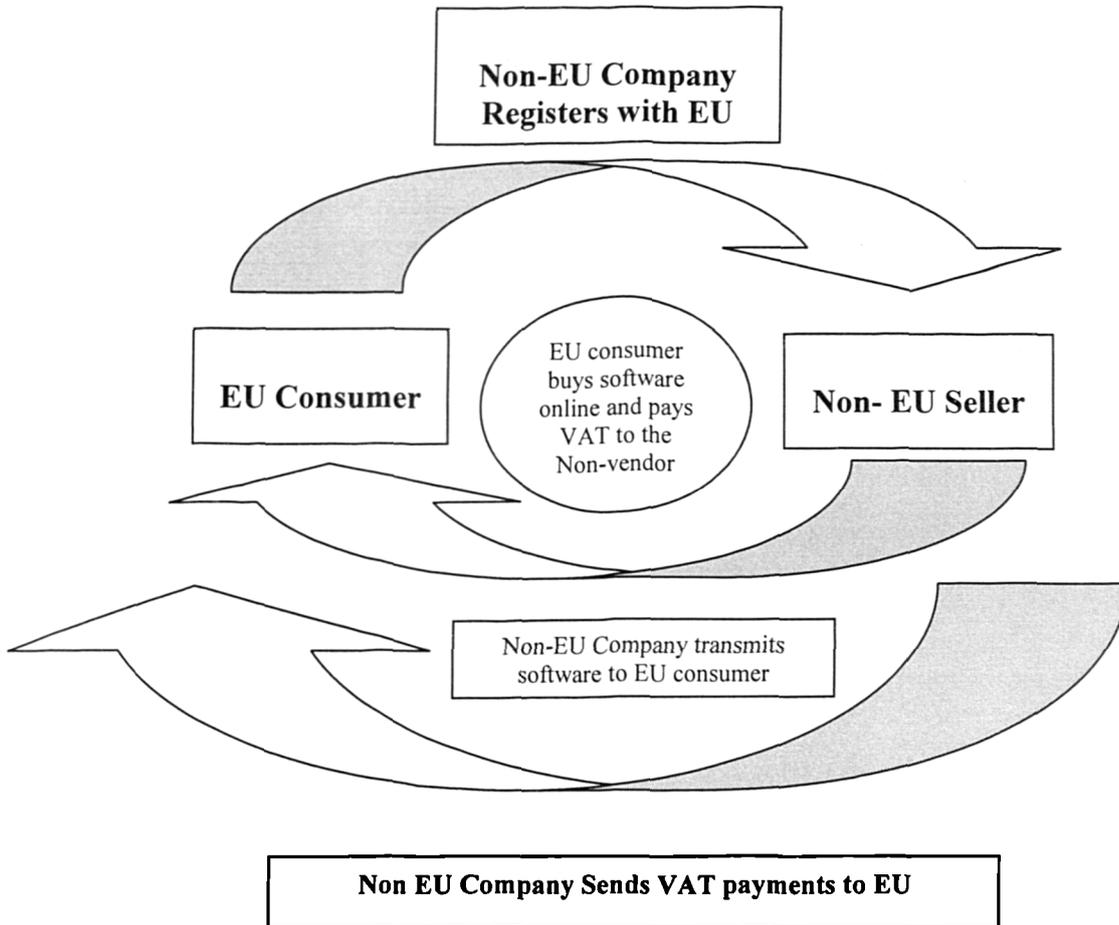
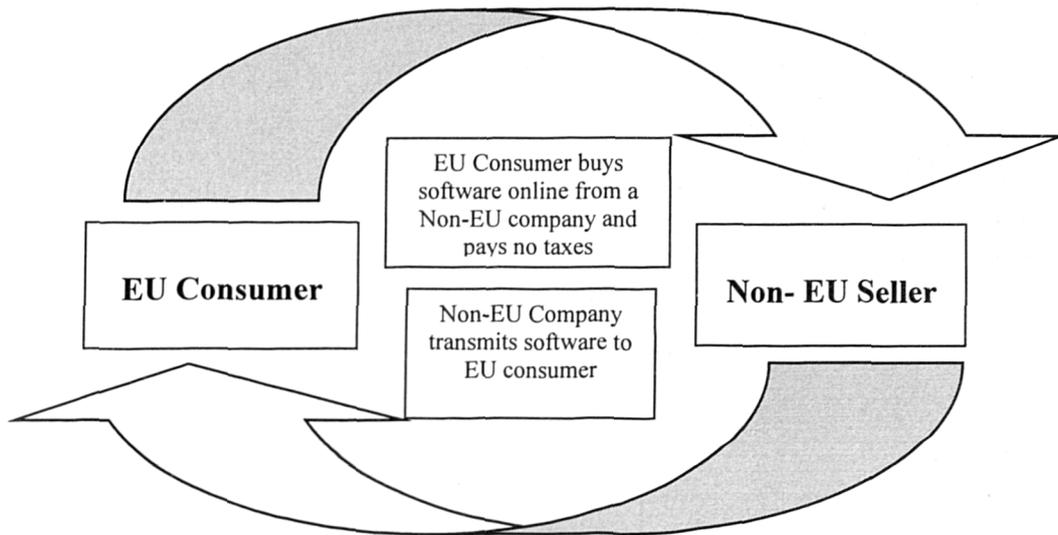
**Table 8.3: Summary for the European Union Product Seller**

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<b>Buyer</b>	<b>Type</b>	<b>What Happens</b>
<b>EU</b>	<b>Consumer</b>	The seller collects the VAT according to the rules of the 'final' consumers though can be registered in one EU country where it exceeds the threshold.
<b>EU</b>	<b>Business</b>	The buyer should self impose the rules of his own country. No VAT is paid to the seller but it is collected when it is imported (at the Customs of the Buyer). The VAT amount paid is calculated according to the buyer's country rules
<b>Non-EU</b>	<b>Consumer</b>	No VAT is charged
<b>Non-EU</b>	<b>Business</b>	No VAT is charged

**Table 8.4: Summary for the Non-European Union Product Seller**

**Current Approach of Collecting VAT on EU Citizens**



**Proposed EU Approach for Collecting Value-added Tax on Transactions Involving EU Citizens**

## 8.5 OECD RESPONSE

During the past few years, OECD had been the most important forum for discussion on the fiscal implications of e-commerce bringing together governments and key business players. The work of the OECD's Committee on Fiscal Affairs produced the Taxation Framework Conditions, which were adopted by the Finance Ministers of the OECD member countries meeting at Ottawa in October 1998<sup>66</sup>. The Taxation Framework Conditions is regarded as a document, which has served both as starting point and point of reference for governments from all over the globe rising to the fiscal challenges of e-commerce. The fundamental guiding principle in the conclusions of Ottawa was that the tenants of taxation that guide governments in relation to conventional commerce should also guide them in relation to e-commerce. The participating ministers in the conference had unanimously agreed that rather than trying to develop a new system of taxation<sup>67</sup>, the existing systems of VAT and GST should be modernised. The Taxation Framework Conditions proposed that taxation of e-commerce should occur in the jurisdiction where the consumption of the good or service takes place. It supports the view that the supply of digital products should not be treated as a supply of goods even though this might initially appear to be running counter to the general rules of traditional consumption taxes<sup>68</sup>.

One of the major works done by the OECD was highlighting the ever-widening gap that exists between the European and US approach to the taxation of online trade. OECD initiatives in the past years has proved to be central effort in the possible world-wide harmonisation of basic taxation principles which probably in future can dismantle existing barriers and lead to a fiscal climate where e-commerce can flourish. OECD member countries are concerned to not only ensure that the consumption tax systems they use are efficient but also to guarantee the preservation of tax base that is threatened to be eroded, in direct and less direct ways. The OECD embarked on a broad revision of consumption tax principles and work of how the consumption tax systems should be up dated was entrusted to a Working Party No. 9 on Consumption Taxes. The Working Party No. 9 acted as a forum to discuss policy, administrative and technical issues. Working Party No. 9 has been actively involved in areas such as financial services, international cooperation, taxation and the environment and in the field of e-commerce, ensuring that '*VAT systems remain a robust mechanism concerning the taxation of consumption in the light of the development of electronic commerce*'<sup>69</sup>.

The major achievement of this Working Party's work had undoubtedly been the drafting of the Ottawa document. Following the Ministerial conference the Working Party No. 9 later embarked on a period of meetings and discussions, examining reactions and comments to the Tax Framework Conditions, with special emphasis to the international character of online trade. This process of studying in further detail

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66 OECD, *Electronic Commerce: Taxation Framework Conditions, A Report by the Committee on Fiscal Affairs of the OECD (1998)* ('Taxation Framework Conditions')

67The controversial Bit tax

68 OECD Commission on Fiscal Affairs, *Electronic Commerce: Taxation Framework Conditions*, at 5, Pt V, para.11(v).

69 OECD, 'Taxing Consumption', available at [http://www.oecd.org/daf/fa/c\\_tax/consum.htm](http://www.oecd.org/daf/fa/c_tax/consum.htm).

the possible ways in which the principles laid down in Ottawa could be put into practise was planned to be concluded by March 2001, and in February 2001 the Working Party presented its latest report. This document however failed to take into account the concurrent developments in Europe. In its report, the Working Party designated clear areas of reference and issues that were to be discussed during international meetings of experts.

The Working Party No. 9 planned to undertake intensive work in trying to address questions such as whether a web-site or a server could constitute a PE for purposes of giving a country power to exercise its tax jurisdiction, to examine and suggest new ways in which the payment for electronic delivered products should be categorised under the existing tax treaties, and most importantly within the ambit of consumption taxes, to build a consensus among OECD member countries but also non-members as regards two separate definitions, that of the place of supply and a workable definition of services and intangible property. *This agenda was set out in the Taxation Framework Conditions itself*, which commissioned the Working Party No. 9 to draw-up the various implementation options that were listed with respect to the areas covered in the Ottawa document. The document itself had emphasised the importance of working hand in hand with businesses, which will ultimately generate the taxes paid to their respective governments. Moreover, the OECD recognised the fact that it would be unable to bring forward truly global solutions to the consumption tax of e-commerce unless it would be able to rally widespread international support to its initiatives from among non-member countries. To make this work easier for the Working Party a number of technical advisory groups (TAGs) were created to focus on specialised key areas relying on the expertise provided by governments and businesses. Several non-OECD countries were involved in the Turku tax roundtable on e-commerce in 1997 and participated in the dialogue on tax and e-commerce in the run-up to the OECD Ministerial conference in Ottawa in October 1998<sup>70</sup> during which the participating delegations set out the general principles that should underlie solutions to problems confronting e-commerce. Various approaches to problems were discussed and organisations were identified that were considered able to develop and implement any future solutions. The Turku conference stated for the first time *'the communication poses challenges for the traditional concepts underlying VAT systems'*<sup>71</sup> and called for an international effort to address these challenges. Among other taxation issues, the conference discussed the present state of application of VAT in its member states and of GST in Canada and New Zealand, agreed that the VAT concept of 'place of supply' should be re-studied and amended according to the new needs of e-commerce, recommended a clearer distinction of goods and services for the purposes of taxing digital trade, examined the distinctions that should be drawn between different types of services, suggested a study on the impact of VAT and customs procedures on e-commerce and also reviewed the US proposals for the Internet to be declared a tariff-free environment whenever it is used to deliver products or services.

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70 OECD 1998 Conference

In late 1997 first OECD efforts started taking shape, namely under the Committee on Fiscal Affairs, to put forward solutions for the many issues outlined in the Turku report. Within a few months the various Working Parties and Technical Advisory Groups started to identify the options that governments could consider individually or collectively. Turku laid the foundations for what was to be agreed upon less than a year later in Ottawa. All 29 OECD Member Countries, 12 non-member countries, 12 international organisations, and representatives from business, trade unions, consumer groups, and other non-governmental organisations attended the ministerial conference.<sup>72</sup>

In October 1998, the OECD succeeded not only in persuading its members that there was a need for urgent debate, but above all agreement, on the rising questions on the taxation aspects of e-commerce, but managed to attract unanimous support from the Finance Ministers of the member countries who signed a document that would lay the foundations for all the future work that the organisation would do in this field. As was already said above, the Ottawa Taxation Framework Conditions are not only concerned with how e-commerce is challenging the traditional systems of consumption taxes but also income taxes and the existing tax treaties. The Committee on Fiscal Affairs managed to secure a number of ground rules that were posed to guide the future treatment of the fiscal issues of e-commerce. Rather than proposing strict rules, at this early stage it was felt that the best approach would be to establish basic principles to which all the participating countries at the Ottawa conference would have no problem to agree.

The most basic principle was that the existing taxation principles that already guide governments in relation to conventional commerce should also guide them in relation to e-commerce. The Committee explained however that this approach was not to be interpreted strictly and that therefore it did not preclude new administrative or legislative measures or changes to the traditional tax principles, provided these new measures were intended to assist in the application of the old tax systems. The Committee had stressed that these new measures should in no case be allowed to give rise to a discriminatory tax treatment of e-commerce transactions. The Ottawa document further provides that whatever these measures to tune the existing tax systems to the new needs created by a world-wide e-commerce might be their application should be structured in such a way to safeguard the fiscal sovereignty of a country, to achieve a fair sharing between countries of the tax base from e-commerce and to continue to avoid double taxation or unintentional non-taxation even in the ambit of digital sales. The most important part of the Ottawa document was the recognition of five fundamental principles that should apply in any fiscal treatment of e-commerce, and particularly in any future specific regulating documents that the OECD might pursue in the future. In fact, the Ottawa document can safely be described as an exercise in the identification of guiding principles. In 1998, it was widely

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71 OECD, 'Electronic Commerce: The Challenges to Tax Authorities and Taxpayers', An Informal Round Table Discussion between Business and Government, November 1997.

72 OECD, Report on the OECD Ministerial Conference, 'A Borderless World: Realising the Potential of Global Electronic Commerce', 7-9th October 1998, Ottawa, Canada.

agreed that it was too early to try seeking more permanent and formal solutions, but rather to clear the ground to be tackled and the problems that should be avoided<sup>73</sup>.

Talks since the Ottawa conference have showed, (as can be seen in the February 2001 report on the '*Consumption Tax Aspects of Electronic Commerce by the Committee on Fiscal Affairs*') how much experts are worried about the business community tend to place particular focus on the principle of neutrality. Sometimes these principles may be in competition with one another and the achievement of a balance between them could be proved more complicated than predicted. Moreover, governments and businesses might have different views on how such a balance should be achieved or on what principle should be given priority while being applied in particular circumstances. This highlights why the OECD insisted on the importance of a close dialogue between governments and businesses, something that was achieved with a certain degree of success in the conferences that have followed Ottawa. In the latest report from the Working Party No. 9 on consumption taxes, it was stated that neutrality is the most important principle, which is given priority in almost all cases. "*The Working Party, while mindful of that particular business focus and determined to foster consensus wherever possible, nonetheless believes it important to give due weight to all the principles, recognising that they form a package*"<sup>74</sup>. Such a statement should not however be considered as a final settlement on the competition in which the principles are put by the often opposing sides of government and business.

More specifically on consumption taxes, the Ottawa document developed another set of minor principles further identifying the ground for the future initiatives of the OECD. In fact, the Taxation Framework Conditions states that the rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where the effective consumption takes place and that effort should be made to achieve an international consensus on the circumstances under which supplies should be held to be consumed in a jurisdiction. The importance of reverse charge, self-assessment, or other equivalent mechanisms was also acknowledged. These systems, according to Ottawa, would, in the case of businesses and other organisations acquiring services and intangible property from outside their country of establishment, allow tax jurisdictions immediate protection of their tax base while ensuring the competitiveness of their domestic suppliers. The document also called on countries to ensure that appropriate systems are developed in cooperation with the World Customs Organisation and in consultation with carriers and other interested parties to collect tax on the importation of physical goods, and that such systems do not unduly impede revenue collection and the efficient delivery of products to consumers.

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73 The five Ottawa principles are goals that should be achieved in the drafting of international agreements on the tax treatment of e-commerce, and the document itself set in motion a process of further meetings and consultations between experts coordinated by a number of Working Parties. The five principles identified in the Taxation Framework Conditions are (i) Neutrality, (ii) Efficiency, (iii) Certainty and Simplicity, (iv) Effectiveness and Fairness and (v) Flexibility. I have discussed these principles while discussing EU's effort in the previous section. OECD, '*Electronic Commerce: Taxation Framework Conditions*', A report by the Committee on Fiscal Affairs, October 1998.

74 Report Working Party No 9

On 12th February 2001, the OECD's Committee on Fiscal Affairs commented on achievements since the Ottawa conference<sup>75</sup>. Gabriel Makhoul, the chair of the Committee was reported to have greeted some of the recommendations, which his Committee forwarded, to the OECD since Ottawa as a "significant step forward in international efforts coordinated by the OECD to address the tax implications of e-commerce." The Committee continued that with respect to consumption taxes, OECD member countries "have made significant progress towards identifying pragmatic ways of achieving the desired result of effective taxation in the place of consumption."<sup>76</sup> The Committee reviewed the conclusions of a report that was presented in February 2001 for public comment by its Working Party on Consumption Taxes which stressed the importance for a clearer definition on the principle of taxation in the place of consumption and the need to identify the collection mechanisms that could best support the operation of the principle of taxation at the place of consumption. The Committee also approved and encouraged the publication of the report inviting the public and businesses in general to comment on the proposal. The Working Party's report also proposed the drawing up of a set of guidelines that would assist in the definition of the place of taxation for cross-border services and intangible property. Particular emphasis was made on how the place of establishment of the recipient business in the case of business to business e-commerce and to the place of establishment, and therefore the jurisdiction of the more common business-to-consumer transactions would be allowed to affect the determination of the place of taxation in the case of cross-border services and intangible goods. The report also delved on the possible development to the collection mechanisms of indirect taxes. The Working Party concluded that in the case of business-to-business transactions the most viable solution was to employ self-assessment mechanisms while in the case of business-to-consumer transactions the most viable options would inevitably be those facilitated by the latest digital technology, although for the time being it would still be easier and safer to rely on the older registration-based systems. It should be mentioned that annexed to the report were two very important documents which sought to summarise and clarify the proposals of the working party with regards the guidelines on the definition of the place of consumption, with particular emphasis on business-to-business transactions, and more specifically recommending approaches to the practical application of such guidelines. This annex could be viewed as the basis for the drafting of a final document that would be presented for formal approval by the Committee on Fiscal Affairs and thus reaching the last stage before a wider international agreement on the definition of the place of consumption of intangible property in the context of e-commerce through the OECD itself.

The Working Party stressed the need that further work was required to comprehensively address the issues, old and new, arising from its months of examination. For this reason the report identified eight areas that should be 'pursued actively in 2001' by the Working Party. These are (i) the verification of the declared jurisdiction of residence of the consumer in respect of business to consumer on-line

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75 OECD, OECD progresses towards achieving an international consensus on the tax treatment of e-commerce, news release, 12th February 2001 at <http://www.oecd.org/media/release/nw01-15a.htm>.

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transactions in order to identify practical and effective methods which appropriately balance the needs of revenue authorities with those of the businesses and consumers alike, (ii) the verification of the status of the customer in order to earmark ways of distinguishing between business and private consumers, which provide sufficient assurance to revenue authorities while minimising specific demands upon business, (iii) the registration of thresholds with the purpose of further clarifying the role that definite registration parameters can play in reducing the compliance requirements for non-resident suppliers, (iv) technology-based and technology-facilitated collection mechanisms and in particular to examine their feasibility, the time-frames in which these could be implemented and also the role that other related standards and tools can play in supporting tax-related functions, (v) encourage and support international administrative cooperation and identify more clearly practical steps how this can realistically be achieved, (vi) strive to develop ways in which the taxation of e-commerce can be simplified, and thus to evaluate rigorously relative priorities taking into account the feelings of the business community, (vii) address compliance-related questions identifying areas of risk in relation to effective assurance and compliance and to study the possible solutions, and finally (viii) developing longer term strategies for exploiting the potential of technology-based mechanisms.

The Committee on Fiscal Affairs welcomed this report and mandated the Working Party to proceed with its sterling work. Moreover, the Committee requested the Working Party to submit a summary and review of the reactions to the report, to draft guidelines and associated recommended approaches for their application to be formally approved by the Committee and to present a comprehensive status report on the progress of the further work that was envisaged in the February report. Meanwhile, "there is much that tax administrations can and should do to share their experience and expertise internationally. It is important that we maintain our efforts to strengthen the emerging international consensus, so as to provide governments and business with the certainty that they need about how taxation rules should apply to e-commerce," Makhlouf added.

In December 2000 the Technical Advisory Group on consumption tax set-up by the Working Party under the framework of the Committee on Fiscal Affairs published its latest report, in which it suggested the adoption of a '*Simplified Interim Approach*'. The report maintains that a simplified tax compliance system, particularly about the tax collection mechanisms that could be implemented by the OECD, would, at least until the approval of long-term solutions with the necessary international support, encourage vendors which have not yet established themselves in any particular country to collect and remit tax just the same. Although the report itself fails to explain in detail how such an approach could be achieved in practice the TAG said this solution would focus on the need to simplify all aspects of tax compliance for non-established sellers, thus including their registration, identification of turnover and calculation of tax, electronic submission of returns and audit processes. More simply, "the thrust of the simplified interim approach is that VAT compliance should be so simple that non-established vendors would be thereby encouraged to register."<sup>77</sup>

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<sup>77</sup> OECD, Report by the Consumption Tax Technical Advisory Group (TAG), December 2000, at p 6.

Although it might be still too early to measure the implications of this approach, the simplified interim approach could eventually become a major backbone in all the work that the OECD is doing in the filed of consumption tax of e-commerce. All the sub-groups entrusted with formulating a clear policy for the OECD that would be acceptable for both governments and businesses can in fact use this approach as their guiding principle. Success for governments by collecting revenues on one hand and success for businesses on the other by limiting as much as possible the burdens of compliance to national and international rules lies undoubtedly in simple but efficient rules. The OECD has to work hard towards the conciliation of these two requirements of simplicity and efficiency to be able to steer a common international approach to the consumption taxes of e-commerce. However, this would be a monumental task, most notably because of the ever-widening views advocated across the Atlantic. Although the OECD itself might develop a final document on the taxation of on-line commerce, its success in practice would depend solely on whether the EU and the US support it. And while the US continues to develop its own ways to deal with the fiscal questions of e-commerce by ensuring one tax moratorium after another, the EU has already experienced how it cannot propose its own solutions if these do not concur with the American approach. One would be tempted to ask whether the OECD's initiatives could also be blocked by opposition raised in the US as happened in the case of the proposed EU directive on the VAT treatment of e-commerce. In this way, simplicity on its own might not be enough and once again, this could be another case confirming the saying that 'money talks'. Both the EU and the OECD seem to try to appease the US in matters of taxation of on-line trade because they can in no way compete with the American giant where hundreds of Internet retail operations are being opened every day.

In a document drawn-up by the business members of the TAG<sup>78</sup>, annexed to the TAG's report, experts have agreed that the simplified interim approach should be adopted to implement the framework conditions of Ottawa in the near term. This document unequivocally states that in view of the present state of development of technology and the inherent limitations of technology to provide more robust technical methods to collect consumption taxes, a simplified approach should be one based on the supplier-registration model. This option has been analysed in much more detail by another of the technical advisory groups established by the Working Party as will be seen shortly below. The same document continues that, "for governments, the primary concern with consumption tax and e-commerce relates to business-to-consumer transactions that involve digitally-delivered services and intangible goods."<sup>79</sup> The TAG's business members' key concerns with respect to the application of existing consumption tax systems to business-to-consumers e-commerce can be summarised in four

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78 Including PricewaterHouseCoopers, America Online, UBS AG, Keidanren, Electronic Data Systems Corporation, Microsoft Corporation, Nortel Networks, KPMG, Swisscom AG, AT&T, ABN AMO Bank and Philips.

79 Report by the Consumption Tax Technical Advisory Group (TAG), Annex V, 'Outline of the Consumption Tax TAG Business members' Recommendations for a Simplified Interim Approach, as submitted to the WP9 Sub-group on Electronic Commerce', November 2000, at p 37.

points: (i) countries do not yet allow vendors to transmit a fiscal invoice solely in an electronic matter thus hindering the opportunities for business to reduce their costs by rendering transactions completely paperless, (ii) technology still cannot offer a totally comprehensive e-commerce tax solution since an element of human judgement is still needed to determine, among others, the tax jurisdiction of the rate of tax for each individual transaction, (iii) in an on-line transaction, businesses are currently unable to verify user-provided information against external data sources because authorities do not make such data available or otherwise this data cannot be accessed instantaneously, or rather, contemporaneously to the transaction, and (iv) compliance procedures are still complicated and lack standardisation, and therefore require a lot of manual work which frustrates the development of system-based and completely automated solutions.

Although the business members said that, the amount of consumption taxes generated by business-to-consumer transactions involving digitally-delivered intangible goods and services are still relatively low, the increase of this form of trade will not necessarily mean that there will also be an increase in the potential for revenue leakage. The business members predicted that in the near term, most supplies of intangible goods and services crossing borders would be made by larger and more sophisticated companies who are capable of dealing with at least some of the complexities of cross-border trade. Moreover, large companies are better equipped and more inclined to be tax compliant because they would want to keep up their corporate image and amidst strong competition protect the operations they have in different countries. The businesses warned the OECD that 'simplification remains the tax authorities' single greatest tool to encourage compliance. The easier and less costly to comply, the greater the level of compliance.

Government officials from over 100 countries met in Montreal (4-6 June) to discuss how to develop and implement such a taxation framework. The Montreal Conference held in from June 4 to June 6 2001, and was hosted by the Canada Customs and Revenue Agency (CCRA) Conference Tax Administrations in an Electronic World by the conference's five co-sponsoring organizations, the Commonwealth Association of Tax Administrators (CATA), the Inter-American Centre of Tax Administrations (CIAT); le Centre de Rencontres et d' Etudes des Dirigeants des Administrations Fiscales (CRÉDAF); the Intra-European Organisation of Tax Administrations (IOTA) and OECD. Representatives of the IMF, UN, World Bank, Regional Development Bank and the EU also participated. The co-sponsors of the meeting set themselves ambitious objectives at the outset. Participants agreed that these objectives had been fully met. *"There was general agreement that the conference should be the start of an ongoing process by which governments work together to improve their tax systems, to exploit the opportunities offered by the new technologies to improve taxpayer service and to enable governments to raise revenues in an effective and equitable way,"* said Mr. Etcheberry, the President of CIAT<sup>80</sup>. The presidents and chairs of the other sponsoring organizations also shared the same view. The ongoing dialogue would focus on four related areas: Identifying best

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80 Tax Administrations in an Electronic World Montreal, 4-6 June 2001, website: <http://www.oecd.org/EN/document/0,,EN-document-101-nodirectorate-no-20-2829-29,00.html>

practices in the area of taxpayer service; improving the capacity of tax administrations to identify taxpayers engaged in e-commerce and to assess and collect tax due; the implication of consumption taxes to cross-border e-commerce transactions; and direct taxation with exchange of information. The attached fact sheet provides an outline of the strategy that would be followed to take forward these discussions. To follow up the Montreal discussions the co-sponsoring organizations would:

- Continue to discuss the key tax administrative issues raised by electronic commerce with a view to developing a taxation framework that can accommodate established taxation principles that operate across a wide range of countries.
- Encourage governments to identify the opportunities provided by the new technologies to improve taxpayer service and to reduce compliance costs for taxpayers and administrative costs for tax administrations
- Assist governments to identify taxpayers engaged in e-commerce and to audit, assess and collect tax due
- More generally, the sponsoring organizations will:
  - Identify outstanding e-commerce issues which require joint work
  - Strengthen the ties between them thereby improving the level and quality of communications and assist in the development of a framework for improved co-operation including areas that go beyond e-commerce

To achieve these aims the sponsoring organizations will:

- Maintain the informal steering group, which has contributed to the success of the Montreal conference.
- Develop links between the websites of each of the participating organizations.
- Develop joint papers on issues of concern to tax administrations where common guidelines and best practices could emerge.
- Develop further the joint training programmes, which already exist between the organizations.
- Explore the hosting of further conferences on topics of mutual interest to their member countries.

# Chapter – 9

## TAXING E-COMMERCE: THE OPTIONS

### INTRODUCTION

As e-commerce forced policy makers to question the principles of taxation, the question is whether technology should adapt to meet the revenue needs of government, or whether government should reform itself to the new means of technology. It is apparent that e-commerce dramatically heightened this dialectic relationship between public policy and technology. This chapter will evaluate principles and options for collection of taxes for e-commerce transactions.

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**9.1 THE NATURE OF THE DEBATE (PREFACE)**

*'The greatest challenge to tax regime is its ability to adjust and adapt to a changing world. The coming of the age of e-commerce, the increased mobility it brings to business and the greater flexibility it offers to the way that transactions and communications are made is the latest and perhaps the most demanding of these challenges'* (Deloitte & Touche, 1997).

In the past, the study of taxation had been largely a parochial issue. It focused, mainly, on the national concerns. Globalisation however initiated international co-operation and development of 'international taxation'. However, even when an international perspective had been necessary, such as when concerning the taxation of truly multinational enterprises, it is still usually approached as an aggregation of national perspectives rather than by adopting a truly international one. The basic incompatibility of the sales tax system (imposed individually by the bulk of the states in the US and a number of other major trading nations) with the VAT system (which applied by EU and certain other jurisdictions) is the major unsolved tax problem. So far, the post-Ottawa process had shied away from a radical solution to this problem as being impractical to implement. It may be so that with the continuing growth in e-commerce, that this cautious position would have to be reconsidered by the OECD and the international community. However, OECD member States have already developed guiding principles for a framework to tax international e-commerce transactions, including a desire to use traditional international tax principles that promote neutral treatment between physical commerce and e-commerce, low compliance costs, and flexible rules to keep pace with technological developments<sup>1</sup>. Indeed developments in technology would be indispensable at least for collection of consumption taxes on e-commerce to provide an automated tax charging and collection mechanism. A system for collecting taxes must be technically feasible, efficient, and cost-effective. The focus of this thesis specifically has been on the issue of taxing intangible products and has been based around three broad questions: What should be taxed? Who should be entitled to tax? How should tax operate for e-commerce?

In response, to the debate few scholars addressed the equity issues associated with taxing e-commerce, mainly in theoretical terms, supported by arguments from traditional public finance economics. Charles McLure, who compared e-commerce events to the history of mail-order catalogues, stated that e-commerce should be taxed (McLure, 1999). McLure (1999) claimed that policies, which are based on the argument that there should be moratorium on Internet taxation until e-commerce is 'mature' enough, would inevitably keep favoured industries from ever 'growing up'. The question of whether e-commerce should be taxed to level the playing field between e-commerce and conventional commerce had been addressed in several other studies, but with mixed results<sup>2</sup>. Those who favour taxation argue that exemptions for e-commerce, combined with current taxation system, would lead to significant distortions that would put conventional retailers at a great disadvantage. Others claimed that the tax

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1 OECD (2000) Committee on Fiscal Affairs, Implementing The Ottawa Taxation Framework Conditions 2.

2 Lukas (1999); McLure (1998)

differential would merely inspire conventional retailers to migrate to the Internet, and that if state governments are genuinely concerned about equity, they should consider 'harmonizing tax rates downward for local retailers,' rather than imposing new taxes on the e-commerce to eliminate the tax differences (Lukas, 1999).

Those making 'infant industry' argument, favour no taxes whatsoever on the e-commerce, justifying preferential treatment as a way to stimulate development of e-commerce<sup>3</sup>. They suggested that taxing e-commerce would throw sand in the gears of economic progress. To support their position they cited the empirical work of Austan Goolsbee on the possible effects of imposing sales taxes and compliance costs on the Internet. Goolsbee (2000) attempted to determine the price elasticity of demand associated with e-commerce sales, and the sales and consumption choices that would follow from such tax drawing upon the data from a survey conducted by Forrester Research in late 1997, he examined the purchasing decisions of 25,000 users as a function of their demographic traits and their residential characteristics, including local sales tax rate. His primary objectives were to determine how the local sales tax rate affected an individual's choice to purchase something online and how it affected the advantage amount of money spent online by the typical consumer. Goolsbee (2000) found that the coefficient on local tax rate was positive and significant, which implied that the higher the local sales tax rate, the greater the amount of money the average consumer would spend online. However, Goolsbee's findings was not without limitation, because the growth of e-commerce has exploded since 1997, it is conceivable that Goolsbee's study suffered from a selection bias in that a majority of the consumers in the sample were more technologically sophisticated and more tax sensitive than typical offline consumer. According to Hellerstein (2001) the principle question here would be: what kind of taxing regime would allow participants in e-commerce to pay and collect taxes in an administratively feasible fashion to those States with a legitimate claim on tax revenues? The objective behind any tax policy would be to find an answer to this question.

## **9.2 PRINCIPLES FOR A NEW TAX**

The principle difficulty in developing an e-commerce taxing regime is that the Internet is still a new medium whose full ramifications are not close to being understood. However with regards to tax policy it is believed that while it would be necessary to modify tax systems of both States and Local governments to accommodate e-commerce, the basic contours of taxation would not likely to be changed dramatically, neither the composition nor the nature of taxation would likely to change fundamentally. OECD's work on consumption taxes, which was firmly based on the Taxation Framework Conditions, expressed similar views. In this context, it would be worth recalling the most relevant emerging conclusions of these conditions:

- *First*, the taxation principles that guide governments in relation to conventional

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<sup>3</sup> James S. Gilmore, III, "No Internet Tax: A Proposal Submitted to the 'Policies & Options' Paper Of the Advisory Commission on Electronic Commerce," available at [www.ecommercecommission.org](http://www.ecommercecommission.org).

commerce should also guide them in relation to e-commerce. In other words, no new taxes should be introduced exclusively for e-commerce.

- *Second*, existing taxation rules must be used to implement these principles.
- *Third*, the process of implementing these principles should involve an intensified dialogue with business and with non-member economies.

Next to, these Conditions the OECD identified a number of Taxation Principles. The most relevant for collecting Consumption Taxes were:

- *First, efficiency* Compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.
- *Second, neutrality, certainty, and simplicity.* The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction. This includes knowing when, where and how the tax is to be accounted. Simplicity often conflicts with other important objectives of tax policy; where this is true, it is necessary to make trade-offs between simplicity and other objectives.

What are the consequences of these Conditions and Principles for the collection of consumption taxes? By endorsing these Conditions and Principles, the member states of OECD have made it very clear that they want to tax the new, digital supplies that e-commerce brought and that they want to do so in the same way as traditional commerce is taxed. McLure Jr (1997) identified the principles, which should guide deliberations in this area of tax policy. *First*, and most obviously, it is important to avoid distorting choices of how to satisfy a given need, taxation rates should not differ, depending on the technology and commercial channels used to satisfy needs. It should treat all commerce equally. It should not discriminate in favour of or against e-commerce; nor should it distinguish between types of products (tangible, intangible, or services) or income from there. As for example, taxation should not distort the choice of how to provide the following products: music (tapes or compact disks vs. downloaded from the Internet), movies (video cassettes vs. downloaded), and reading materials (printed books, magazines, and newspapers vs. downloaded). *Second*, it is important not to distort the choice of technology used to provide particular intangible products and services: for example, the provision of television signals over the air using traditional broadcast technology, via cable using wires (provided by either cable companies or public utilities) and fibre optic cables, or via direct transmission to satellite dishes. *Third*, taxation should not affect the choices of whether and how to 'bundle' various goods and services for purposes of pricing. This means that there should be neutrality towards bundling. For example, whether to include software on compact disks sold with books and whether to use lump-sum prices or itemized charges for basic and enhanced telecommunications and for the services of ISPs and OSPs, including, especially, the bundling of content and Internet access. *Fourth*, taxation should not distort location decisions or trade between jurisdictions and should neither favour nor penalize local producers and distributors. This has several dimensions, including avoidance of tax-induced distortions of competition in the provision of tangible products, intangible products, and services. Location distortions may have either interstate or international dimensions. Administration of (and compliance with) any taxing scheme should be relatively easy. Nexus should be predicated on the presence of taxable activity in the taxing jurisdiction. The possibility of nexus by affiliation, as well as

nexus by agency, should be recognized. Jurisdictions at a given level (Nations and in case of sub-national authorities) should adopt essentially uniform nexus rules, definitions of tax bases, and administrative practices (but not necessarily uniform tax rates). Nevertheless, work should be done in order to reduce the number of taxing jurisdictions and blending of rates. Taxpayers should not be expected to comply with a multitude of locally differentiated rates. Given the difficulty of determining the physical location of customers buying electronic content, vendors should be allowed to assume that the billing address is the destination of such content though this approach is potentially vulnerable to abuse.

There is need for International cooperation and this cooperation must extend beyond bilateral treaties and even beyond multilateral agreements between signatories to 'play by the rules'. It must include the possibility of sanctions against nations that provide a *hospitable setting for those who desire to operate in a sheltered environment in order to avoid taxes on their sales and income*. The challenge for policy makers would be to respond according to these principles to ensure that needed government expenditures could be funded and that tax distortions are minimised, a significant part of the response would necessarily involve greater international co-operation. It is increasingly difficult for individual countries to manage their tax bases in the face of these forces and, in particular, some tax practices have led to harmful and distort cross-border 'tax competition'. It should be noted here that this is not attempt to stall the economic progress by protecting the prior technology from the onslaught of new technology. It is also not a plea to penalize the prior technology by giving the new technology tax breaks. An example should help to clarify this point. It may turn out that, for non-tax reasons, video rental stores would be unable to compete with companies offering to download videos electronically over the Internet<sup>4</sup>. However, being forced to pay taxes what their cybernetic competitors do not pay should not hamstring video stores. More generally, there is no reason tax law should favour out-of-state vendors or differentiate between tangible products, intangible products, and services, as it does now (McLure, 1997).<sup>5</sup>

The principle objective in designing taxation for e-commerce would be to achieve neutrality. Neutrality avoids distortion in choices involving consumption, production, location, or methods of finance<sup>6</sup>. Neutrality would be especially important in the taxation of e-commerce, because of the ease with which transactions can be diverted in response to differential taxation, for example, to seemingly different products that satisfy the same underlying needs, to quite similar products that are delivered through different distribution channels, or to sources located elsewhere. How to achieve economic neutrality in VAT and Sales tax involving cross-border sales? An economically neutral sales tax would apply at a single rate to all consumption occurring within a given jurisdiction, but not to business purchases or to exports (Due and Mikesell, 1994). This would be true, whether a given product is tangible or intangible

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4 Professor Negroponete predicts that 'videocassette-rental stores will go out of business in less than ten years.' Similarly, Ray Hammond writes, "... I wouldn't buy shares in Blockbuster until I heard about the company's plans for Net delivery)." Hammond, at 201.

5 McLure, 1997 at p 383

6 Joel Slemrod (1990) Optimal Taxation and Optimal Tax Systems, 4 J. Econ. Persp. 157

or a service and whether it is produced domestically or imported. In principle, VAT produces this result automatically, since both imports and domestically produced products are subject to tax, exports are zero-rated, and business taxpayers are allowed a credit against tax liability on sales for VAT paid on purchases. While full competitive neutrality was achieved with respect to the supply of services by EU suppliers to non-EU customers, non-EU suppliers were not required to charge VAT when they supply services to EU customers and there by caused competitive disadvantage, however in response to this, as discussed in chapter –8 the EU Commission amended the VAT Directive by which EU suppliers would not be required to charge VAT on online transactions involving non-EU customers so that competitive neutrality with respect to EU exports to the to non-EU countries is achieved and VAT treatment of non-EU suppliers with EU taxable persons would be taxed at the location of the EU customer following a destination based taxation<sup>7</sup>.

McLure (1997) argued it would be much more difficult, even in theory, to achieve a neutral sales tax than to achieve a neutral VAT. It would not be difficult to eliminate two of the most glaring defects of state sales taxes, the ‘bright-line physical presence’ test for use tax nexus and the exemption (or differential treatment) of intangible products and many services, reduce sentence length though changes have long been high on the agenda of tax reform in this area. But in order to do so, greater uniformity of state laws (as it is applicable to different States of US) simplified administrative procedures, rationalizing nexus rules as well as and unifying the tax treatment of tangible and intangible products and services will be required. Otherwise, it would create an unacceptable burden of compliance, especially on small business firms making interstate sales and aggravate the problem of pyramiding the collection of tax on both business inputs and sales to final consumers.

In order to implement the solution in the context of the sales tax, it would be necessary to distinguish between sales to businesses and sales to households; the former should be exempted, even if the later is taxed. This problem is ordinarily addressed by exempting certain goods (essentially those that are unlikely to be bought by households) and by allowing firms to buy on a tax-exempt basis. It is useful to ask here whether households or business firms derive most benefits from government services. To the extent that public services are provided primarily to households and are complementary to private consumption, it is appropriate to levy a tax on consumption (as under a destination-based VAT or an

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<sup>7</sup> As discussed in chapter-8 EU suppliers would not be required to charge VAT on online transactions involving non-EU customers so that competitive neutrality with respect to EU exports to the US is achieved. The rules for supplies by EU suppliers to EU customers remain unchanged, i.e.

- Supplies to taxable persons remain subject to the reverse charge procedure, and
  - Supplies to consumers are taxed where the supplier has established his business.
- The VAT treatment of non-EU suppliers, however, would change completely: B2B-transactions with EU taxable persons will be taxed at the location of the EU customer; the tax would levied via the reverse charge mechanism which requires EU taxable persons to withhold, remit and account for VAT.

Non-EU suppliers who sell their products to EU consumers would have to register with the VAT authorities of a member state of their choice. They would be required to levy VAT on their transactions with EU consumers if their revenues exceed a certain threshold amount. VAT would have to be levied at the rate that is applicable in the member state where the consumer lives.

ideal sales tax) as a quasi-benefit tax; to the extent they are provided primarily to business and are complementary to production, a production-based tax (such as an origin-based VAT) would be more appropriate. While there is no easy answer to this question, but a consumption-based tax levied under the destination principle would be more appropriate. If this is true, tax should be applied to all sales to consumers in a given State; mail-order sales and their tangible and intangible counterparts in e-commerce should not be exempt just because vendors lack a physical presence in the State.

### 9.2.1 DESTINATION OR ORIGIN BASED TAXATION

Consumption taxes are designed with the basic assumption that the seller and the buyer are located within the same taxing jurisdiction or at least within compatible trading systems. The collection and payment burden is placed upon the buyer, usually the retailer, while the economic cost is placed upon usually the consumer. The problem arises in relation to cross-jurisdictional sales where the *source* country differs from the destination country. The Destination principle is almost universally employed for the sales taxation of international trade in tangible products, and the European Union is moving toward the destination-based taxation of intangibles and services<sup>8</sup>. Destination-based taxation has several conceptual advantages. *Firstly*, destination-based taxation is much less likely to distort the location of economic activity than origin-based taxation. *Second*, taxation of consumption is *probably* a better proxy for the benefits of public services than taxation of production. Perhaps most important is the political attraction of the destination principle. It is not difficult to understand why those producing for the domestic market would not quietly accept origin-based taxation, as it would imply that they would have to pay taxes while their foreign competition would not. Under the destination, principle market jurisdictions would collect the same tax on domestic and foreign production. Similarly, exporters are not likely to take kindly to a suggestion that exports should be taxed. It is relatively easy, ignoring legal obstacles for the moment, to collect destination based taxes on tangible products. Where there are fiscal borders, as between nations that are not members of a common market, tax can be collected at the border. Within a common market, it may be possible for vendors to collect the tax, because they know where they ship goods. However, increasingly important technological shift from the production and sale of physical to digital products would cause destination-based taxation difficult to implement. In contrast to products traditionally sold in shops and in a format that gave them some physical content, digital goods do not have physical characteristics. Consequently, it would be difficult to determine the location of purchasers. By comparison, origin-based taxation would be relatively easy to implement in this case.

So far, the VAT and sales tax systems have concluded that the destination model should apply whereby the tax system, and tax rate of the destination jurisdiction should apply, the idea being that if consumption is the appropriate subject of taxation, then the country in which goods are received for consumption receives the revenue generated by that consumption. This however created a tax problem, which is also economically disruptive in two particular ways:

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<sup>8</sup> EU Directive VAT on Digital Sales

- The source country has the ability to enforce compliance but no revenue interest in doing so, while the destination country has a revenue interest in doing so, while the destination country has a revenue interest in compliance but has difficulty with enforcement, especially in relation to non-corporeal goods such as digital products purchased over the Internet.
- The source country saves money on enforcement and potentially gains other revenues gains occur in area such as income taxes from jobs and property taxes on centres of production, and thus business within such jurisdictions can enjoy a competitive tax advantage.

Would origin-based taxation solve these problems? While no solution is perfect and each solution creates new issues, origin- based taxation would seem to answer the major problems posed by a destination-based tax and would be relatively easy for the States to implement. By this system Sales tax or VAT would be collected by the seller only at the point of origin of the e-commerce sale which would be defined to be the seller's physical location. This would eliminate sellers' concerns over nexus uncertainties, analysis of whether items were taxable or exempt in the various jurisdictions, privacy concerns, and the costs of collection and remittance to hundreds, if not thousands of jurisdictions. Effectively, the major concerns raised by a destination-based tax would be answered. Particularly some scholars in USA have suggested an Origin based consumption taxation system as a solution. Origin based taxation appear to solve most compliance complexities of US sale/use tax. The e-commerce seller would be required to collect all the state and local taxes in the jurisdiction where the 'principal place of business' of the e-commerce seller would be located, regardless of where the product would be shipped or the service performed. The seller's sales would be subject to one tax rate and one jurisdiction's tax laws and regulations. The tax revenue thus generated would be allocated according to the laws of the state where the vendor's principal place of business is located. Under an origin-based system, e-commerce seller would have to collect at only one rate of tax, on only one tax base (i.e., one set of tax laws and regulations -- that of the state of their principal place of business). This would minimize the burden on the seller in a number of ways. Another positive aspect would be the statutorily extinguished 'use tax' liability of the buyer even if the customer's home state imposed tax a higher tax rate.

Because the e-commerce vendor would be physically located in the state asserting taxing jurisdiction, there would be no question that nexus exists. Actual physical presence would satisfy due process nexus concerns as well as the substantial nexus requirements of the US Supreme Court. Another potential positive impact of origin-based taxing would be maximizing of revenue collected. As nexus considerations would be eliminated, it is reasonable to assume that many transactions that currently escape taxation would now be taxed. In addition, because it would be easy to administer and enforce by the taxing officials of the state in which the seller is located, non-compliance would be greatly reduced. Finally, because the sales would be taking place in one location, local taxes imposed in that jurisdiction would also be collected, eliminating the need for a uniform state tax rate, which many states might be legally or politically precluded from providing.

However, some could view this as a serious invasion of the purchaser's privacy, which would require the seller to obtain information from the purchaser and deliver that information directly to tax officials. It would be an intrusion that would be unique to e-commerce purchasers because such information is generally not taken from traditional 'bricks and mortar' buyers. As under an origin-based proposal the purchaser would be treated the same for tax purposes as a customer who walked into the vendor's store, there would be no need for inquiry into the identity or location of the buyer. Further origin-based taxation would maintain the autonomy of local governments and other local taxing jurisdictions that are strongly opposed to the one-tax-rate-per state idea (this is particularly important for US State and Local governments). This would be both politically realistic and would respect the notion of federalism that is, that the federal government should not overly intervene in the taxing prerogatives of the states.

Under a destination-based VAT, tax is applied to goods imported into the taxing jurisdiction and exports from the jurisdiction occur tax-free. Under an origin-based VAT, exports are subject to tax, and tax is applied only to the value that is added after importation. Under this proposal as with brick and mortar retailers, the buyer is viewed as visiting the sellers' location, rather than the seller visiting the buyers' location. For example, if an online software company in the United Kingdom uploaded a game to a customer in USA (say Oregon), the software company would be liable for the VAT. The same would be true if the software were uploaded to a customer in London, Moscow, or an airplane crossing the Atlantic. Under an origin-based tax system, taxes would be collected on all sales out of the relevant tax jurisdiction, and no businesses would be expected to collect taxes for a government from which they derive no benefits. Whether or not the digitised sale is taxable is to be determined by the seller's state just as, when a buyer physically enters a state to make a purchase. As the GIIC has noted, "*an origin based system, universally applied, would simplify indirect taxation, would result in more effective enforcement, would reduce opportunities for avoidance, and would eliminate double taxation.*"<sup>9</sup> Since businesses are subject to audit, the expected compliance rate with origin-based tax rules is also very high. Mechanisms to enforce compliance with domestic consumption tax collection responsibilities are already in place, so a move to origin-based taxation would place no additional burdens on businesses and little (if any) new burdens on national tax administrations. A final benefit of origin-based taxation although most governments do not see it that way is that such a system fosters robust tax competition between states. Critics of origin-based taxation often warn that such tax competition will not be healthy, but rather be a 'race to the bottom' for nations, undermining their ability to raise revenue.<sup>10</sup>

It has been also argued that origin-based taxation would disadvantage domestic producers on their export sales. Although the design of a nation's tax system can affect export competitiveness, the true burden facing domestic producers is the overall level of taxation. Thus, businesses subject to VAT collection responsibilities may not suffer any competitive disadvantages under an origin-based system if tax rates are kept at reasonable levels. A Deloitte & Touche paper puts it this way:

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9 GIIC FOCUS

*'A consumption tax without border tax adjustments (an origin-principle consumption tax) ... at first appears to create a disadvantage for domestic producers relative to foreign producers in overseas markets. Border tax adjustments, though, may not be the only mechanism operating to maintain neutrality. Other self-executing adjustments by the markets, such as reductions in wage rates or in the value of the domestic currency, could offset wholly any potentially detrimental trade effects of origin-based taxation on exported goods'.<sup>11</sup>*

European Commission has recognized the inherent benefits of origin-based consumption taxes, albeit only on an internal basis. In 1996 in its work program for the gradual introduction of a new common VAT system, the Commission announced its intention to advocate a switch from taxation at destination to taxation at origin for sales within Europe. The changes being contemplated are minor. 'All transactions giving rise to consumption in the EU,' a Commission paper states, 'would be taxed from their point of origin so that the existing remission/taxation mechanism for trade between Member States would be abolished'<sup>12</sup>. However, switching to origin-based taxation would shift substantial amounts of tax base from developing countries to developed countries where digital contents originates particularly to US (In essence, for B2B transactions the origin principle is tantamount to exempting the tax free imported component of final products from tax). There is also a further argument that countries of origin are quite likely to tax digital content preferentially, in order to prevent its providers from locating elsewhere. This implies that digital content would have a substantial competitive advantage over non-digital equivalents, which would be taxed under the destination principle. This would create further downward pressure on the tax base of developing countries.

### 9.3 ANALYSIS OF OPTIONS

While it is generally appropriate that existing taxes should apply to e-commerce, but it would have to be based on four objectives. *First*, it might not be easy to achieve this objective. It might be necessary to rethink how some laws could be applied to make them suitable for the world of e-commerce. *Second*, some current tax laws, especially at the state level, made no sense; such features include, 'nexus' rules, especially as applied to mail order sales, failure to tax sales of tangible products, intangible products, and services equally, application of sales taxes to many purchases by business. Defects that were already troubling would become increasingly untenable and fundamental restructuring would be needed. *Third*, to solve either of these problems would require substantial cooperation between jurisdictions, be they the states or nations; unilateral solutions are not likely to be satisfactory. *Finally*, it is possible that 'no new taxes' would not be the right answer; and would require further research and analysis. There is reasonable concern that such laws should not be enacted that lack flexibility. Opponents of preferential treatment of e-commerce generally agree that there should be 'no new taxes' on the Internet and 'no taxes' that discriminate against e-commerce, but believe that e-

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10 Charles E. McLure used this phrase to describe the consequences of taxing sales at their origin during testimony before Advisory Commission on E-Commerce on June 22, 1999.

11 Deloitte & Touche LLP (1996) 'Consumption Tax Issues Briefs,' *Fundamental Tax Reform*, available at <http://www.dtonline.com/TAXREF/trissue.htm>.

12 Eggermont, Tino (1998) 'The Commission's work programme for the gradual introduction of the new common VAT system,' European Commission, 1998, available at [http://www.ecu-activities.be/1998\\_2/eggermont.html](http://www.ecu-activities.be/1998_2/eggermont.html)

commerce should be taxed like other commerce. Hence, taxation should seek to be neutral and equitable between forms of e-commerce and between conventional and e-commerce. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation. Proposals to make the Internet a 'consumption tax-free zone' would be attractive, but would have potentially devastating economic, tax, and social consequences. It would distort several dimensions of consumer and business choices: in favour of content delivered on-line, instead of in tangible forms, and in favour of products that could be delivered on-line as electronic content, relative to products that could not be (notably tangible products and services that cannot be delivered in this manner). Although it would avoid some problems otherwise created by bundling, but would pose formidable problems of classification, especially the need to distinguish between telecommunications (presumably taxable) and Internet access. Moreover, it would be grossly unfair, both horizontally and vertically. Particularly pernicious is the effect it would have in undermining local retail stores. By exempting a large and growing fraction of consumer purchases, *this policy would require higher tax rates to raise a given amount of revenue*. Finally, it would do nothing to remedy the problems of the existing system.

The discussion earlier in chapter-7 showed that the incredible growth in e-commerce. This growth has been accompanied by the creation of a small number of brands, which have become global leaders in the marketing and distribution of their products through the Internet. The world's most popular e-tailer Amazon.com though largely associated with its beginnings as a pure online bookseller, its success and business model have expanded considerably. The market leadership and consumer acceptance of Amazon.com is also evident in other market segments by e-tailers such as 'Cdnw' (for music) and 'eBay' (for auctions). What has now becoming evident is that these Internet companies were using their high market values to eliminate their competitors and to take over other companies with high market shares<sup>13</sup>. The January 2000 announcements of the mergers of 'America Online', 'Time Warner and EMI, was an example of such acquisition. During 1999, eBay acquired Butterfield & Butterfield (the 134 year old San Francisco auction house) and Kruse International (the upscale car auctioneer). Similar alliances and acquisitions had also been identified by the OECD as prevalent in international markets<sup>14</sup>. In 2000, a survey by Ernst and Young showed that only 10% of etailers indicated that acquisition of other businesses was part of their growth strategy<sup>15</sup>. However if this 10% was the top end of the market, backed with the enormous buying power their share prices gave them, their size would continue to grow as they work towards reducing competition and competitors in their chosen markets. Of even more concern for traditional retailers was the research by 'Jupiter Communications', which

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13 Although the current trend in Dotcom companies in past one year was not encouraging but it is believed by most commentators that this downward trend would be temporary and was result of the much of wider economic stagnation .In any case for the past two years major world economies were slowing down. It would appear in coming years that 'bust' of e-commerce companies during this period was exception rather than rule

14 OECD (1998) 'The Economic and Social Impact of Electronic Commerce: Preliminary Findings and Research Agenda', 24 August 1998, DSTI/ICCP (98) 15/PART5, p 12, Available at [www.oecd.org/subject/e\\_commerce/summary.htm](http://www.oecd.org/subject/e_commerce/summary.htm).

15 Ernst & Young (2000) 'Global Online Retailing', January 2000, p 47.

indicated that the growth in e-commerce would be at the expense of traditional sales<sup>16</sup>. Jupiter found that only 6.0% of business-to-consumer Internet sales in 1999 were incremental sales, it was suggested that this figure would increase to 6.5% for Internet sales in 2002. This data indicated that 94% of Internet sales were sales that traditional retailers would have expected to make. While some proportion of these sales would be facilitated by the Internet operations of traditional retailers, the fact remains that most of the sales of the pure Internet e-tailers were sales poached from traditional retailers.

The continuation of the preferential taxation treatment of e-commerce would continue to exacerbate the sales losses of traditional businesses as the e-tailers exploit their unfair advantage. It could be expected that this may result in the forced closure of many traditional businesses offering services to local and remote communities. How would the local bookstore compete against the purchasing power of companies such as Amazon.com and Barnes and Noble when this is also backed by a tax-advantaged position for their Internet sales? Bruce and Fox (2001) study based on e-commerce sales drawn from Forrester Research Inc.'s annual forecasts for the years 2001 through 2011 forecasts showed that the incremental revenue loss from e-commerce sales would estimated to be 41% more than previous report of 2000 had indicated due to higher business-to-business (B2B) transactions forecast by Forrester. In 2001, e-commerce caused a total state and local government revenue loss of \$13.3 billion. By 2006, this loss would be more than triple to \$45.2 billion and in 2011; the loss would be \$54.8 billion. Ernst & Young's survey leading to their 'Third Annual Online Retailing Report' asked respondents why they shopped on line<sup>17</sup>. While the convenience factor was important, 'because items cost less' was the response from 16% of those surveyed while 12% noted that it was because they did not incur sales tax. Both responses indicate that consumers were price sensitive on the products they purchase online. Similar findings had also been reported by Goolsbee (1998)<sup>18</sup>. However, the price benefits that online purchases are facilitating are not available to all. After analysing several surveys across a number of countries, the OECD concluded that:

*"One consistent finding across many countries is that there is a strong positive correlation between the use of information technology (PC ownership, access to the Internet) and household income: for every \$10 000 increase in household income, the percentage of homes owing a computer increases by seven points"<sup>19</sup>.*

The US demographic figures from Ernst and Young<sup>20</sup> report indicated that while 53% of households have PCs, only 34% were online and only 17% had shopped online. These online buyers had a weighted average annual income of \$59 000. Clearly, indicates that online shopping is not available to all. This situation is unlikely to change while many families cannot afford computers. This

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16 Jupiter Communications (1999) Press release, 'Digital Commerce Growth Will Be at Expense of Off-line Dollars', 4 August 1999. Available at [www.jupitercommunications.com/company/pressrelease.jsp?doc=pr990804](http://www.jupitercommunications.com/company/pressrelease.jsp?doc=pr990804)

17 As reported by CyberAtlas, 'Online Holiday Shoppers to Triple' 9 November 1999, available at [www.cyberatlas.internet.com](http://www.cyberatlas.internet.com)

18 Goolsbee, Austan, 'In a world without borders: the impact of taxes on Internet commerce, November 1998, p 5

19 OECD, 'The Economic and Social Impact of Electronic Commerce: Preliminary Findings and Research Agenda. Executive Summary', 19 August 1998, p 14

20 Ernst & Young (2000)

demographic figure is not only applicable for US but it is representative for all countries that have been part of or have experienced the growth of e-commerce. If similar studies were carried out in developing countries, the disparity would be more striking.

If preferential tax treatment continued with e-commerce the possibility of running into the risk of widening the gap of digital divide would also increase. It would cause a societal inequity where higher income earners would be able to benefit from buying goods cheaper online through a distribution network not available to many lower income families. It is hard to justify why this inequity should be further subsidised by the non-application of sales/use taxes and VAT to e-commerce. It is also enlightening in this regard to look at what consumers are buying online. In order of most popular Internet purchases, consumers are buying computers, books, CDs, electronics, and toys. Given the demographics of *online buyers as outlined above*, these consumer items are not those that inherently need Government subsidisation. Usage of the Internet and the e-commerce facilitating growth quickly amongst those in society who can afford access and have the purchasing power to enjoy the benefits it is providing. To minimise the adverse effects of this growth on society, it is believed that the current inequity in treatment between the distribution method of goods and services purchased from traditional sources and those purchased over the Internet should be removed. In summary, taxing all e-commerce would perpetuate or aggravate compliance and administrative problems. However, exempting it would create inequities and distortions and would aggravate existing problems of classification and compound discrimination.

### 9.3.1 BIT TAX

A number of alternative approaches have been canvassed, with some attention being paid to the notion of a 'bit tax'. 'Bit tax' was radical or even revolutionary because it did not fit into the framework of income or consumption taxation. In essence, this would involve charges being levied upon Internet users dependent on the volume of data transmitted to or from their equipment. Arthur Cordell and Thomas Ide (1994) first proposed the notion of such tax in 1994. Cordell and Ide argued that existing tax bases were no longer appropriate in an environment where the major economic activity was represented by the transmission of data.

The report '*Building the Information society for US All*'<sup>21</sup> produced by a group of independent experts appointed by the European Commission, suggested in 1996 that the Commission investigate:

*"Appropriate ways in which the benefits of the Information Society (IS) can be more equally distributed between those who benefit and those who lose. Such research should focus on practicable, implementable policies at the European level which do not jeopardise the emergence of the IS. More specifically, the expert group would like the commission to undertake research to find out whether a 'bit tax' might be feasible tool in achieving such redistribution aims"*

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21 Available from [www.meritbbs.unimaas.nl/publications/2-hleg.pdf](http://www.meritbbs.unimaas.nl/publications/2-hleg.pdf)

Cordell (1997) argued that a tax on gasoline did not slow down the development of the automobile industry. However, this happened because implicit assumption of inelastic demand for cars. Whether the demand for accessing the Internet and more importantly the demand for using the Internet is inelastic remains an open question.

United Nations in the report 'Globalisation with a Human Face', also argued in favour of 'bit tax'.<sup>22</sup> This report advocated levying a tax on data sent over the Internet, with the funds used to support the development of a telecommunications infrastructure in the least developed countries of the world. Statistics produced by NUA Surveys indicate a massive variation in access to and use of the Internet between the various regions of the world. Some 304.6 million people are estimated to use the Internet. A tax of 1 per cent per 100 e-mails, it was estimated, would yield an annual income of \$70 bn. The UN proposal was not received a warm welcome in the developed world, where it was described as 'an unnecessary and burdensome tax on the Internet.' To this end, the E.U. had also rejected the proposal of 'bit tax':

*"In order to allow electronic commerce operators to reap the full benefits of the Single Market (i.e. the European Market), it is essential to avoid regulatory inconsistencies and to ensure a coherent legal and regulatory framework for electronic commerce at EU level... In parallel, a number of key horizontal issues affecting the entire electronic commerce activity need to be addressed. These include data security, protection of intellectual property rights and conditional access services, privacy, as well as a clear and neutral tax environment."*<sup>23</sup>

The main appeal of the bit tax was its ostensible simplicity. As specified tax rate was applied to the volume of interactive cyberspace 'traffic' travelling over lines run by telecommunications carrier companies, and the resulting tax revenues would then flow directly to national governments. However, such simplicity may be more apparent than real, for the bit tax presents vexing problems of how to accurately measure the volume of data flow and how to precisely separate which data would taxable and which would not. Consequently, tax collections could either be inflated or deflated, bringing unintended distortions in the tax base and instabilities in the tax system. Additionally, taxing business transactions in a different manner specifically because they were conducted by means of e-commerce violates the principle of tax neutrality.

A distinguishing characteristic of the bit tax was that the entire burden of collecting and remitting the tax was borne by the carrier company. While it could be argued that carrier companies possess the necessary technical and labour resources to effectively perform such a function, but it would be uncertain who, in the final analysis, would shoulder the bulk of the tax burden or incidence. Would carrier companies absorb the cost, or would they pass it onto consumers? If carriers choose to pass the costs onto consumers (a reasonable assumption, it appears), they would have to do so in a non-neutral manner because carriers lack the means to accurately separate e-commerce from non-e-commerce data flows. With a bit tax, there could also be problems with enforcing compliance on the part of carrier

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<sup>22</sup> Available from [www.undp.org/hdro/99.htm](http://www.undp.org/hdro/99.htm), published in July 1999

<sup>23</sup> A European Initiative in Electronic Commerce (1997) Communication to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions, COM(97) 157. May 1997. <<http://www.cordis.lu/esprit/src/ecomcomx.htm>>

companies. Without a central international regulatory agency to oversee the carriers, there would be difficulties in ensuring that companies collect the correct amount of tax and accurately allocate the funds to the designated governments. The arguments put forward for the 'bit tax' were not grounded in free market based economic principles, but rather in moral and sociological reasoning. With limited exceptions, a free market operates most efficiently when taxes were designed to minimize interference with the production processes. Thus, the burden of taxation is limited to the revenue raised, and there is no additional cost lower economic output. A 'bit tax' failed this basic principle of taxation because it would discourage electronic transmission of information. Economic resources would be wasted through efforts to minimize the 'bit tax'. Further it would also be counterproductive in that it burdens e-commerce and its productivity. For example, software companies might continue to ship magnetic tapes and cartridges rather than to use the more efficient method of transmitting the data electronically.

Electronic transmission of information is highly efficient and thus extremely low in cost. Proponents of the 'bit tax' further argued that the price of electronic transmission does not reflect true value. They argue for taxing electronic transmission according to bits rather than value, as is the case under a value-added tax. Experience has shown that when prices were set by social planners rather than by the operation of the free market, the loss of economic efficiency can be enormous. There was no reason to believe that the marketplace cannot adjust pricing systems to better align prices with resource availability. And with regard to the discouraging effect of the 'bit tax' in freeing up Internet resources, while congestion on the existing Internet is a valid issue today, however discouraging use of the Internet would not be a desirable goal. It would premature to conclude that existing taxes could not be successfully adjusted to accommodate technological innovations. The solution to these problems lied not in new taxes, but rather in technology itself. What would be required is a matter of clearly defining tax compliance requirements and making reasonable adaptations to existing tax rules and then as a matter of taxpayers adapting the technologies to satisfy those compliance requirements.

### **9.3.2 SHARE OF TAX BASE**

To nullify this distortion and improve overall cross-frontier compliance, a solution must aim for ease of administration, revenue neutrality and a fairer allocation of the tax revenues between source country and destination country. Taylor (2000) in his paper '*An Ideal E-Commerce Consumption Tax in a Global Economy*' proposed a solution, which is feasible and beneficial to both the developed, and developing countries. It was based on the principle of sharing of consumption tax base between the origination and destination country. By sharing revenue, the destination country gives the origination country an interest in insuring that the consumption tax is collected and paid. The destination country should determine the rate of the tax or the exemption from the tax and this ensures tax neutrality along with safe guarding the interest of developing countries (as they have the more consumers) as I have said earlier that the economic impact of loss of revenue over the developing countries will be more. According to the proposal, the origination country would receive an amount of tax equal to the half of

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its VAT or sales tax rate or half of the VAT or sales tax of the destination country; whichever of the two is less. For origination countries, which do not have applicable consumption taxes, the proposal provides an incentive of 3% or half of the destination jurisdiction's consumption tax, in form of an export tax. In order that the system works it would need a universal product coding system, which would determine which product is subject to what tax. The coding system would also help the taxing jurisdictions to modify the rates of tax for different products or to make certain product exempted from tax. In order to avoid the pyramiding of consumption taxes, a business will be allowed to register in each country where it actively conducts its business through one or more physical establishments. Sales to registered businesses will be exempted from consumption taxes on the theory that the goods are being used as inputs for subsequent taxable sales. The collection and payment of the tax would be entrusted upon 'Trusted Third Party', which could be the credit card companies or the banking institutions, and they would receive a fee for their administration of the system. Universal software would be developed in order to determine the tax due on each transaction. The primary audit function would fall on the destination country. As so many taxing jurisdictions will be involved, hence safeguards should exist for protecting privacy of business and consumer.

By sharing of the tax, revenue the system should work as it creates interest for both jurisdictions. Neutrality is preserved within the jurisdictions because the consumption rate does not vary based on the origin of sale. The proposal is quite attractive for EU as it solves the problem of designating the point of sale within the EU and preserves most of the VAT tax base for sales outside the EU. However had not been written with *EU Directive on Digital sales* in mind, which would make the proposal not adaptable in principle. The most of the state and local government would support the proposal as it solves the problem of nexus in light of *Quill* decision. One of the main drawback of the proposal is that there is possibility that business and other entities would claim the exemption which when they are not entitled to it. There is also possibility that the consumers would claim to reside in low or no tax jurisdictions but actually reside somewhere else. The approach offered in this paper may not be conceptually pure, the option works with much burden imposed on the destination country. The rate of tax or exemption would be determined by the destination country, even the primary audit function would fall on the destination country however by providing a share in tax to the origin country when their responsibility would be limited only to the monitoring would cause undue favouritism to them. The basic problem for e-commerce in case of consumption taxes is how to determine the location of the consumer, which has not fully been explored in the proposal.

### 9.3.3 OECD TAG PROPOSALS

During the past few years the OECD Working Party on Consumption Taxes working together with business and non-member countries has focussed on five possible mechanisms for the collection of consumption taxes, which were:

- Self-assessment;
- Registration of non-resident suppliers;

- Tax at source and transfer;
- Collection by trusted third parties; and
- Technology based solutions

While each of the Collection mechanisms, the Working Party identified has its merits and may be suitable and workable in different circumstances. To see which mechanism was the most preferable a simple test could be used. These mechanisms have been judged by the test used by the Working Party, which contained three criteria. The first criterion was the *feasibility of implementation*. Does the mechanism have a chance of implementation? The second criterion was the *compliance burden*. The costs for business of implementing and applying the mechanism should not be so high, that it would prevent compliance and encourages avoidance and evasion. The third and final criterion was the *administrative burden*. If perception costs were too high, levying consumption taxes becomes inefficient.

The first collection mechanism the Working Party examined was Self-assessment, also referred to as Reverse Charge. Under a Self-assessment system, recipients would be required to determine the tax owing on imports of digital supplies, and to remit this amount to their domestic tax authority. While this mechanism is very suitable for transactions where the recipient is a business, it is unpractical for transactions where the recipient is a private consumer. This mechanism to a smaller or larger extent, in use for business-to-business transactions in most OECD-countries. It had proven feasible and effective and carried a low compliance and administrative burden. For transactions involving private customers however, it is highly ineffective. Taxing a private customer for the digital supplies he had received would be very burdensome on both the consumer and the tax authority in terms of compliance and control. Taxing private individuals using this mechanism delivered high compliance and administrative costs. Asking consumers to keep books and to control those books was too costly and burdensome on both taxpayers and tax administrations. This means that the risks of evasion and avoidance would be high. Therefore, Self-assessment could only be considered as an option for business-to-business transactions.

The second Collection Mechanism the Working Party worked on was registration of non-resident suppliers. A registration system obliges a non-resident seller of digital supplies to register in a jurisdiction in which he had made sales. After registration the seller would have to charge, collect and remit the consumption tax to the country in which the consumption took place. For example, a French seller of digital music, selling music to customers in Canada, would have to register in Canada. He would have to charge and collect Canadian consumption tax and remit the tax to the Canadian tax authorities. From an administrative point of view, registration of non-resident suppliers would for the most part be feasible and effective. Since the registration of non-residents would not directly require bilateral or multilateral arrangements, this mechanism was relatively easy to implement<sup>24</sup>. Difficulties arise in terms of identifying non-resident suppliers as well as in imposing registration requirements and

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<sup>24</sup> EU is applying VAT on Digital sales using the principle of this system as I have discussed in Chapter-8

enforcing obligations on non-residents. This mechanism could therefore increase the costs for tax administrations and for businesses. This would be particularly true for businesses making supplies in multiple jurisdictions. Without international co-operation, there would also be a risk that businesses would not comply. In the absence of international co-operation, this mechanism depended on the voluntary compliance of non-resident suppliers. To encourage voluntary compliance, registration and remitting the tax should be as simple as possible.

The third collection mechanism the Working Party examined was the Tax at Source and Transfer system. Under this system, a business would collect consumption tax on sales made to non-resident consumers and remit the tax due, to its domestic revenue authority. In turn, the domestic revenue authority would forward the tax revenue to the revenue authority of the country of consumption. This system shares some features with the registration system. A major difference of course being that under a system of tax at source and transfer, suppliers of digital supplies would not have to register abroad. Businesses can handle their foreign consumption tax responsibilities with their national tax authorities. However, this mechanism requires tax revenue to be transferred from one tax jurisdiction to another. This meant that considerable international agreement would be needed, which would make this mechanism difficult to implement. The significant compliance cost associated with the registration mechanism would be largely avoided by the tax at source and transfer mechanism. This however would be replaced by significant administrative costs that come with the required international co-operation.

The fourth option the Working Party considered was an entirely new system where third parties would be enlisted to collect consumption taxes on transactions between recipients and suppliers of digital supplies. A Trusted Third Party would monitor the transactions between buyers and sellers and would charge the buyers consumption taxes and remit these taxes to the tax authorities of the countries where consumption took place. If a Trusted Third Party were to take on the levying and recovery of certain taxes, both compliance and administrative costs could be kept to a minimum. Making this mechanism appealing in this respect. The feasibility of this mechanism however, is point of concern. Shifting the onus of collection onto a commercial organisation is troublesome. Today, many consumption taxes are collected by businesses that do not receive compensation for this imposed task. Granting a fee for the collection of consumption taxes in the field of e-commerce makes it difficult to deny an allowance in other fields. Ideally, tax collection would be part of a package of services for which the supplier would be willing to pay. Otherwise if there were no business opportunity paying the tax collection bill would not be easy.

The fifth and final mechanism for collecting consumption taxes the Working Party studied, were Technology driven options. Various technology-based and technology-facilitated options had been debated. One approach would involve the use of tamper-proof software, which would automatically calculate the tax due on a transaction and remit (through a financial intermediary) the tax to the jurisdiction of consumption. Bilateral agreements would provide for the verification by the tax

authority in the jurisdiction from which the supply was made. It would do so on behalf of the tax authorities in the jurisdiction where the consumption takes place and would also monitor the installation and operation of the software. Technology based or technology facilitated options offer a broad range of possible mechanisms. As these mechanisms were still to be developed, it was possible to incorporate requirements for feasibility and effectiveness into the development programs. Doing this would by definition produce mechanisms that could easily be implemented and carry low administrative and compliance costs. Now such technology driven collection mechanisms are being developed. They would probably be available in the medium term. However, none of these methods was perfect, but several of them could be used together to provide a reasonable level of assurance. The need for simplicity provided some guidance on who should be registered for tax, and with which authorities. The need for automation made it clear that any feasible solution must be technological to a high degree. The WP9 paper argued that technology could support any part of the overall compliance model<sup>25</sup>. However, one could go further and say that technology-based solutions should not be seen as a separate class of solutions at all. They simply provide ways to make it easy for taxpayers to account for tax and to give tax authorities the confidence that they were collecting the right amounts of tax, given the legal relationships between taxpayers and authorities have been selected.

#### 9.4 A GLOBAL TAX SYSTEM

*'When there is no longer a territorial imperative, when the place of residence and the investment are no longer a given but a choice, when added value is generated in too abstract a fashion for its creation to be assigned a precise location, taxation is no longer a sovereign decision'. (Jean-Marie Guehenno, 1995)*

Adam Smith, economist and philosopher, in his book *Wealth of Nations* (1776) said that all should contribute to taxation as a sign of citizenship of a state. He based his principles on the propositions: ability to pay, certainty of payment, convenience and minimal cost. The relationship between taxation and emergence of the modern state, in short, was one of 'mutual constitution': taxes made the state, and the state made taxes<sup>26</sup>. Put it differently, the modern state grew and flourished in part because it made fiscal sense at the time: it was a form of political organization that was particularly good at collecting taxes. Given this history, it is not surprising that taxation was, and continues to be, viewed as a central function and prerogative of the state. However, this history now raises intriguing questions for present day. Territorial States are not particularly well suited to the task of taxing non-territorial e-commerce, as e-commerce would grow in volume, States would experience a corresponding decline in their ability to tax global e-commerce. More precisely, States would experience a decline in their 'autonomous' taxing abilities. Does this unprecedented phenomenon of e-commerce necessarily argue for creation of a new tax system?

The current international tax scene is rich in initiatives and programs, however it lacks:

- clear and transparent mechanisms for the coordination of these programs; and

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25 paragraph 53 Working Party 9

- a real input from developing countries in the way programs are constructed and international tax issues debated.

There are very few forums where developing countries can speak and raise their concern. The development of e-commerce has not brought any fundamental change to this apart from participation of some developing countries in OECD. However, as most commentators would agree developing countries must be able to raise the revenue concern, which is required to finance the services demanded by their citizens and the infrastructure (physical and social) that would enable them to move out of poverty and taxation plays the key role in this revenue mobilization. Merilee Grindle, Professor of International Development and author of *Ready or Not: The Developing World and Globalisation* admitted that '*many developing countries are at a competitive disadvantage in the context of rapid globalisation . . . in fact, the gap between the wealthy North and much of the poor South is likely to increase in the years ahead, despite some development success stories.*' In almost all developing countries, it would be the elites who benefit significantly from e-commerce and to a broad extent globalisation. However, they stand in great contrast to most of the population in their countries, whose low levels of education, health, and economic security put them at a particular disadvantage in the knowledge-driven era of globalisation. If these are the challenges faced by developing nations, one can well imagine the impact on impoverished countries, which suffer from weak economic, legal, and political institutions, making them unattractive for domestic or foreign investment.

Some commentators argue that the stage is set for a global fiscal showdown. With the increase frequency of e-commerce, it is conceivable that until international consensus would be achieved on the taxation of global trade, less developed countries would find themselves at the losing end in terms of revenue collection from businesses conducted within their own territories. On the other hand, developed nations with the technological infrastructure to carry on business in a borderless world would have the edge. Potentially, a redistribution of billions of tax dollars is at stake. The issue is not just about shifting of tax revenue from less developed to more developed countries but more importantly, the potential leakage from state treasury coffers arising from the use of offshore centres and tax havens. It may be timely to think 'outside the box' with the view to develop a new mechanism to deal with the new challenges of a new era. One possible measure perhaps is to move towards some form of global tax system. As Owens noted '*...if governments are to meet successfully the challenges posed by Internet tax systems, a coordinated approach is required*<sup>27</sup>.'

Global taxes are not a new idea. Legal scholar James Lorimer referred to the idea in his 1884 book *Ultimate Problems of International Jurisprudence*. Many of the most famous economists of the earlier twentieth century likewise considered it, including Alfred Marshall, John Maynard Keynes, and James Meade<sup>28</sup>. Around the time of the United Nations' founding in 1945, economists and policy makers

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26 Hoffman and Norberg (1994) at 303

27 Owens, Jeffrey (1997) *The Tax Man Cometh to Cyberspace* (presented at the Symposium on Multi-jurisdictional Taxation of Electronic Commerce, Harvard Law School) .

28 Frankman, Myron J. (1996) "International Taxation - The Trajectory of an Idea from Lorimer to Brandt," *World Development*, vol. 24 (May).

often spoke of the need for robust international economic policy to avoid the dangers of renewed depression and war. To them, global economic management and even global wealth, redistribution seemed not only desirable but a logical necessity.

In order for global tax system to work it would require to overlay and extend the national tax system beyond traditional frontiers. Ideally all the National tax systems would be harmonised by a combination of standardised administrative procedure and technology to achieve some degree of consistency and it is envisaged that such a tax would be administered by a world nominated agency, collected based on international transactions and/or consumption, and the funds applied towards approved global causes such as eradication of poverty, health and social development. Those who advocate for global tax system argue that, whether the taxation of international e-commerce is pursued through an enhanced source based system, an enhanced residence-based system or formulas apportionment system, whether consumption taxes for the cross-border e-commerce follow origin based, destination based or share of tax base, a considerable broadening and strengthening for international tax regime would almost certainly be necessary. It is difficult to imagine any such arrangement that would not involve the creation of some form of permanent international tax institution. Some day, an international political authority would levy global taxes. However, at present, a robust authority of this kind, with sufficient accountability *and* enforcement powers, does not exist.

No one would argue the moral case for having a global tax system. However, a relatively simple moral argument requires substantial political will and motivation for implementation. Hence, one of the most strenuous criticisms of proposals for global taxation concerns its feasibility. An examination of the actions that must be taken if a system of global taxation is to be adopted and implemented indicated that although it is feasible from a technical, legal, and administrative point of view. The biggest obstacle would be political. Keat (2001)<sup>29</sup> expressed that in order for a global tax system to be successfully implemented, there must be consensual acceptance by all countries, particularly the richer and more developed nations, which are likely to bear the heaviest burden. There must also be general agreement by these nations that the funds collected be used for approved global priorities, judiciously determined based on prescribed qualifying criteria. The global tax system must also reflect fair principles of taxation but, most importantly, the richer and more developed nations must have the political will to support such an initiative, otherwise it would be an exercise in futility. However the supposed reluctance of individual States to commit to an international effort could be explained, at least in part, by the prisoners' dilemma analysis of international cooperation. In the classic prisoners' dilemma, when two people are suspected of a crime. If neither person confesses, there would be not enough evidence to convict either one of them. At the same time, however, when there is an offer that whoever confesses first would receive a reduced sentence. Each prisoner knows that the optimum outcome for both of them could be accomplished if both prisoners agree not to confess. However,

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<sup>29</sup> Prof Khoo Chuan Keat is Executive Director and Tax Leader, Pricewaterhouse Coopers Malaysia.

neither one of the prisoners could be sure what the other would do. Consequently, both confess, giving the authorities all the information they would need to convict both the prisoners.<sup>30</sup> The same scenario could be applied loosely to international efforts for an agreement to global tax system. Even if each state may recognize that, it would be in the general interest of the international community to agree to such system. However, this outcome would be only optimal if a sufficient number of States comply. If this does not occur, States that would be party to the agreement would suffer a competitive disadvantage in comparison to those states that choose to remain outside the agreement. Therefore, without sufficient international consensus, no State would feel confident in entering into a binding agreement.

Any global tax system would also violate the accepted principles of taxation:

- **Administrative simplicity:** This is not possible because of both the likely governing structure and the need to coordinate tax collection across some 200 jurisdictions.
- **Flexibility:** The governing structure makes it unlikely a *global tax system could* respond appropriately to changing economic conditions and, in fact, makes it likely the system would respond perversely.
- **Transparency:** The complications of a global tax would make it difficult to impossible to determine where true tax incidence fell, particularly given the tax would be on international movements, not end users.
- **Fairness:** For the preceding reasons, both vertical and horizontal fairness could not be ensured and would likely be *deliberately violated*.

The growth of e-commerce has made it quite apparent the differences between the tax systems of the world. If the objective is not maintain the tax base and protect revenue loss, then what would be required is to develop tax rules that make compliance simple and inexpensive. Any solution that would meet these requirements would have to base on simple and consistent tax rules across all jurisdictions. Would this require developing a global tax system? Perhaps not in the way many of the proponents of the global tax system would like to see. The best method in the short term may not be the best method in the long term: new technology may change our preferences. However, guiding principles must be kept simple and must be realistic. Complexity puts businesses off, and would lead to their withdrawing co-operation. In addition, human beings are too precious a resource to spend on the routine administration of amounts of tax, which are individually small.

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30 D, Fudenberg and J. Tirole, *Game Theory* (Cambridge Mass: MIT Press, 1999)

# Chapter – 10

## TAXING E-COMMERCE- A PROPOSAL

### INTRODUCTION

This chapter evaluates the role that different components could play and analyses if and in which way these components can assist for collection of taxes from cross border e-commerce transactions. It will take a closer look into the different technical possibilities for the development of an effective system for collection of consumption tax. If technology poses challenges, it also offer solutions.

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10. AN ISP BASED SYSTEM

10.1 INTRODUCTION

*“The policy and practice are symbiotic and need to be developed concurrently. Resolving policy independently of understanding the required technology may lead to policy that can't be practically implemented”* OECD (2000)

A. E-COMMERCE: THE ELEMENTS

Who owns the Internet? The most straightforward answer is that no one does. There is no single body, which controls all activities on the Internet. It simply exists and virtually impossible to 'switch off'. The Internet comprises of three layers. *First*, it exists as 'physical' infrastructure- as a data network 'managed' at a high level by international bodies and at a day-to-day level by various public bodies and corporations whose networks it uses. *Secondly*, it exists as a 'service' infrastructure provided by ISPs who offer access to the Internet. *Thirdly*, it exists at the level of users. At the 'physical level', the networks within different countries are funded and managed according to national policies. Links between countries are managed by agreements between telecommunication providers. There are number of different bodies responsible for the management of the Internet. At the highest level, there are a number of organisations responsible for the technical and engineering aspects of the Internet such as the Internet Engineering Task Force (IETF) and the Internet Research Task force. The Internet is the first global institution that has no government. This is both one of the Internet's greatest strength and one of its weaknesses. Ownership is distributed between countries and their governments, corporations, universities and the major telecommunications utilities. Corporation, firm, or an individual owns each individual computer attached to the Internet. Large telecommunications utilities such as 'BT' own a large percentage of the physical wires and routers over which data are transferred.

At the 'service level', it includes hardware and software tools that provide an interface with the various network options, and to the customer premises equipment (CPE), or terminal equipment, which is a generic term for privately owned communications equipment that is attached to the network. At this level as far as the user is concerned, the body responsible for managing the Internet are the ISPs. ISPs own the majority of the servers on which information is hosted are also responsible for ensuring that individuals and companies have access to Internet under the terms of the agreement signed between the parties. ISPs are self-regulating. They are subject to the laws of the jurisdiction in which they are based. It is the ISPs which the represent the public face of the Internet for most users. They are the connectors between the second 'service level' and that of the 'third level' of user (or e-commerce). Theoretically, it is the 'third level' of Internet, which raises the most complex legal challenges.

The information content transferred over the network consists of text, numbers, pictures, audio, and video. However, the network does not differentiate among content, as everything is digital that is, combinations of ones and zeros. Once content has been created and stored on a server, vehicles, or

messaging and information distribution methods, carry that content across the network. The messaging vehicle is called *middleware software* that is located between the Web servers and the end-user applications and masks the peculiarities of the environment. Messaging and information distribution also includes translators that interpret and transform data formats. Messaging vehicles provide ways for communicating non-formatted (unstructured) as well as formatted (structured) data. Unstructured messaging vehicles include fax, electronic mail (e-mail). Structured documents messaging consist of the automated interchange of standardized and approved messages between computer applications. Purchase orders, shipping notices, and invoices are examples of structured document messaging. For the purposes of e-commerce, existing messaging mechanisms must provide reliable, unalterable message delivery that is not subject to repudiation, to be able to acknowledge and give proof of delivery when required.

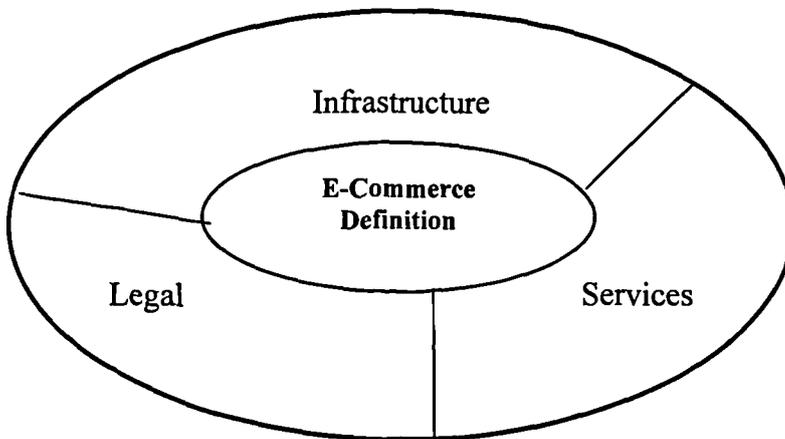
Three quite separate trends (business document exchange, logistics management and global networking) came together to provide the infrastructure and technology for e-commerce. Further a combination of regulatory reform and technological innovation enabled the growth of e-commerce. The technological innovations associated with e-commerce have also influenced at different of levels. For example, consider *Amazon.com*, which has transformed the market structure for bookselling. The drivers of value for consumers may not be the reduced prices and wide selection of books that it offers in the market. Instead, it is the technology-assisted ability to quickly search a large database for specific kinds of books and to receive recommendations on books that are similar to which they wish to purchase. Such 'recommendation technologies' in e-commerce, as well as a broad spectrum of other technological innovations, are based on computer software and systems, and telecommunication and hardware technologies. Thus, there are things that become possible in e-commerce that are not normally associated with the bricks-and-mortar world of traditional business.

Any regulatory framework must be aware of the various competing interests present in an analysis of the process of e-commerce. E-commerce from a communications perspective, is the delivery of information, products/services, or payments via telephone lines, computer networks, or any other means. From a *business process* perspective, it is the application of technology toward the automation of business transactions and workflows. From a service perspective, e-commerce is a tool that addresses the desire of firms, consumers, and management to cut service costs while improving the quality of goods and increasing the speed of service delivery which provides the capability of buying and selling products and information on the Internet and other online services. From a *production process* point of view, e-commerce converts digital inputs into value-added outputs through a set of intermediaries. For example, in the case of online trading, production processes can add value by including more value-added processing (such as trend analysis) on the raw information (stock quotes) supplied to customers. Broadly speaking, e-commerce emphasizes on improvement of the execution of business transactions over various networks. These improvements may result in effective performance (better quality, greater customer satisfaction, better corporate decision making), greater economic efficiency (lower costs), more rapid exchange of information between parties (high speed, accelerated,

or real-time interaction). More specifically, e-commerce enables the execution of information-laden transactions between two or more parties using interconnected networks. These networks could be a combination of telephone system, cable TV, leased lines, and wireless. Information based transactions were creating new ways of doing business and even new types of business. Hence, what exactly is a transaction? Transactions are exchanges that occur when one economic entity sells a product or service to another entity. A transaction takes place when a product or service is transferred across a technologically separable interface that links a consumer (client) with a producer (server). When buyer/seller transactions occur in the electronic marketplace, information is accessed, absorbed, arranged, and sold in different ways. To manage these transactions, e-commerce also incorporates transaction management, which organizes, routes, processes, and tracks transactions. E-commerce also includes consumers making electronic payments and funds transfers. Hence, the combined effect of the economic forces, customer interaction forces, and technology-driven digital convergence are fuelling interest in e-commerce. The context of this discussion showed e-commerce was born out technology, it's growth and working process is fuelled by technology and it's elements and part of that same technology, hence it is conceivable that all these forces would have to be taken into account when consideration is given on development of any tax collection mechanism.

**B. E-COMMERCE: THE COMPONENTS**

The growth potential of e-commerce rests three main components: the services, infrastructure, and the legal. These components combine and interact at the time of any e-commerce activity.



For development of physical infrastructure e-commerce relied on a variety of technologies, the development of which are proceeding at breakneck speeds (e.g., interconnectivity among telecommunications, cable, satellite, or other Internet 'backbone;' Internet service providers (ISPs) to connect market participants to that backbone; and end-user devices such as PCs, TVs, or mobile telephones). The service component of e-commerce is responsible for making sure that commercial transactions can actually take place and provides the viable means for committing to such transactions, such as providing means for making payment over the Internet possible (through credit, debit, or Smart cards, or through online currencies). It also makes possible the distribution and delivery (whether online or physical) of those products purchased over the Internet to the consumer. The legal component

affects the conduct of those businesses engaging in and influenced by e-commerce, as well as the relationships between businesses, consumers, and government. Examples include technical communications and interconnectivity standards; the legality and modality of digital signatures, certification, and encryption; and disclosure, privacy, and content regulations. The detail of each the components and their regulation depends on the requirements of the perspective. The boundaries of the components would accordingly vary to accommodate the scale of need of a perspective. The importance of infrastructure is more for communication and business process perspective. Similarly, the legal regulations that provide certainty of electronic contract, privacy, consumer protection, and taxation would be of much importance for services perspective.

**C. E-COMMERCE: SECURITY**

However there are concerns, which transcend the individual components, security is such an issue. The major barrier to e-commerce today is the lack of security. It is essential to have the technological means to provide authentication, identification, accountability, and liability in electronic transactions. All participants, from all perspectives, must have a confident reliance on user identities, while holding each party liable to perform their role in the transaction. Consequently, such technologies are needed which bolster consumer confidence in the reliability of the relationship, the identity of the participants, and the veracity of the materials being exchanged concern could only be addressed through a combination of technology and legal rules. Accordingly, all the three components should integrate and interact in order to develop a sustainable policy for tax collection and enforcement. E-commerce would not reach its full potential until customers perceive that the risks of doing business electronically have been reduced to an acceptable level. Confidentiality, authentication, integrity, and non-repudiation are the four most important ingredients required for trust in e-commerce transactions. The objective to develop an inter-related system where all these concerns are simultaneously addressed with relative simplicity.

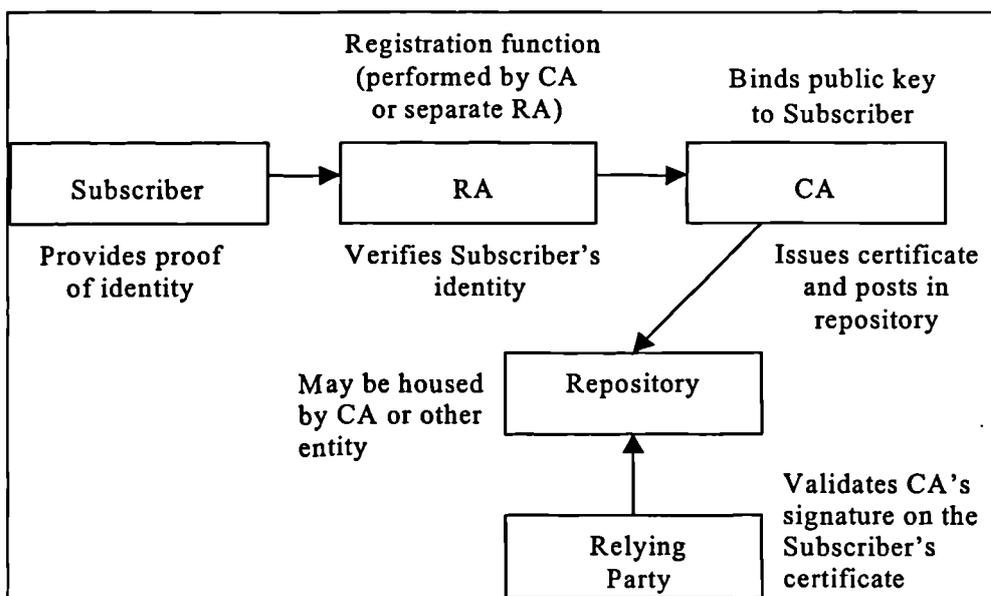
In view of the available technology, it seems proper that 'digital certificate' together with 'Certifying Authority' can provide the much need assurances. Digital signatures can be used to provide the necessary authentication, integrity, and non-repudiation. PKI uses public/private-key pairs two mathematically related keys. Typically, one of these keys is made public, by posting it on the Internet for example, while the other remains private. Public-key cryptography works in such a way that a message encrypted with the public key can only be decrypted with the private key, and, conversely, a message signed with a private key can be verified with the public key. A subscriber first obtains a public/private key pair (generated by the subscriber or for the subscriber as a service). The subscriber then goes through a registration process by submitting their public key to a Certification Authority or a Registration Authority (RA), which acts as an agent for the CA. The CA or RA verifies the identity of the subscriber in accordance with the CA's established business practices (that may be contained in a Certification Practice Statement), and then issues a digital certificate. The certificate includes the subscriber's public key and identity information, and is digitally signed by the CA, which binds the

subscriber's identity to that public key. The CA also manages the subscriber's digital certificate through the certificate life cycle (meaning, from registration through revocation or expiration). In some circumstances, it remains important to manage digital certificates even after expiry or revocation so that digital signatures on stored documents held past the revocation or expiry period can be validated later. A transaction submitted by a customer to an online merchant via the Internet can be encrypted with the merchant's public key and therefore can only be decrypted by that merchant using the merchant's private key ensuring a level of confidentiality. Confidentiality can also be achieved using Secure Socket Layer (SSL), Secure/Multipurpose Internet Mail Extensions (S/MIME), and other

protocols, such as Secure Electronic Transaction (SET). The following example illustrates how a digital signature is generated and verification process for a reversible asymmetric cryptographic algorithm (such as RSA). Suppose a customer wishes to send a digitally signed message to a seller. The customer would have to run the message through a hash function (meaning, a mathematical function that converts a message into a fixed length block of data, the hash, in a fashion such that the hash uniquely reflects the message – in effect, it is the message's 'fingerprint'). The customer then would transform the hash using the algorithm and the customer's private key to create the digital signature, which would be appended to the message. A header would also be appended to the message, indicating the seller's email address, the sender's email address, and other information such as the time the message being sent. The message header, the message itself, and the digital signature would then be sent to the merchant. The customer can optionally send his/her public key certificate to the merchant in the message itself. The e-mail software in such a way usually does all of this that the process is transparent to the user. The following diagram illustrates the process of using a subscriber's key pair to ensure the integrity and authenticity of a message sent by the customer (subscriber) to a seller.

To determine whether the message came from the customer (meaning, authentication) and to determine whether the message has not been modified (meaning, integrity), the seller validates the digital signature. To do so, the merchant must obtain the customer's public key certificate. If the customer did not send his or her public key certificate as part of the message, the seller would typically obtain the customer's public key certificate from an online repository (maintained by the CA or another party acting as the agent of the CA, or any other source even if unrelated to the CA). The seller then would validate that the customer's digital certificate (containing the customer's public key) was signed by a recognized Certification Authority to ensure that the binding between the public key and the customer represented in the certificate has not been altered. Next, the seller would extract the public key from the certificate and uses that public key to transform the digital signature to reveal the original hash. The seller would then run the message as received through the same hash function to create a hash of the received message. To verify the digital signature, the seller would compare these two hashes. If they match, then the digital signature validates and the seller would know that the message came from the customer and it was not modified from the time the signature was made. Digital signatures can also be used to provide a basis for non-repudiation (meaning that the signer cannot readily deny having signed the message). In order for these technologies to enable parties to securely conduct e-commerce, one

important question must be answered. How would we know in the digital world that an individual's public key actually belongs to that individual? A digital certificate, which is electronic document containing information about an individual and his or her public key, is the answer. This document is digitally signed by a trusted organization referred to as a Certification Authority (CA). The basic premise is that the CA is vouching for the link between an individual's identity and his or her public key. The Certification Authority provides a level of assurance that the public key contained in the certificate does indeed belong to the entity named in the certificate. The digital signature placed on the public key certificate by the CA provides the cryptographic binding between the entity's public key, the entity's name, and other information in the certificate, such as a validity period. For a relying party to determine whether a legitimate CA issued the certificate, the relying party must verify the issuing CA's signature on the certificate. The public keys of many common Root CAs (as later defined) are pre-loaded into standard Web browser software (for example, Netscape Navigator or Microsoft Internet Explorer). This allows the relying party to verify the issuing CA's signature using the CA's public key to determine whether a trusted CA issued the certificate. The purpose of a CA is to manage the certificate life cycle, which includes generation and issuance, distribution, renewal and re-key, revocation, and suspension of certificates. The CA frequently delegates the initial registration of subscribers to Registration Authorities (RAs) which act as agents for the CA. In some cases, the CA may perform registration functions directly. The CA is also responsible for providing certificate status information through the issuance of Certificate Revocation Lists (CRLs) and/or the maintenance of an online status checking mechanism. Typically, the CA posts the certificates and CRLs that it has issued to a repository (such as an online directory), which is accessible to relying parties. A Registration Authority (RA) is an entity that is responsible for the identification and authentication of subscribers, but does not sign or issue certificates. The following diagram illustrates the relationship between the subscriber and the RA and CA functions.



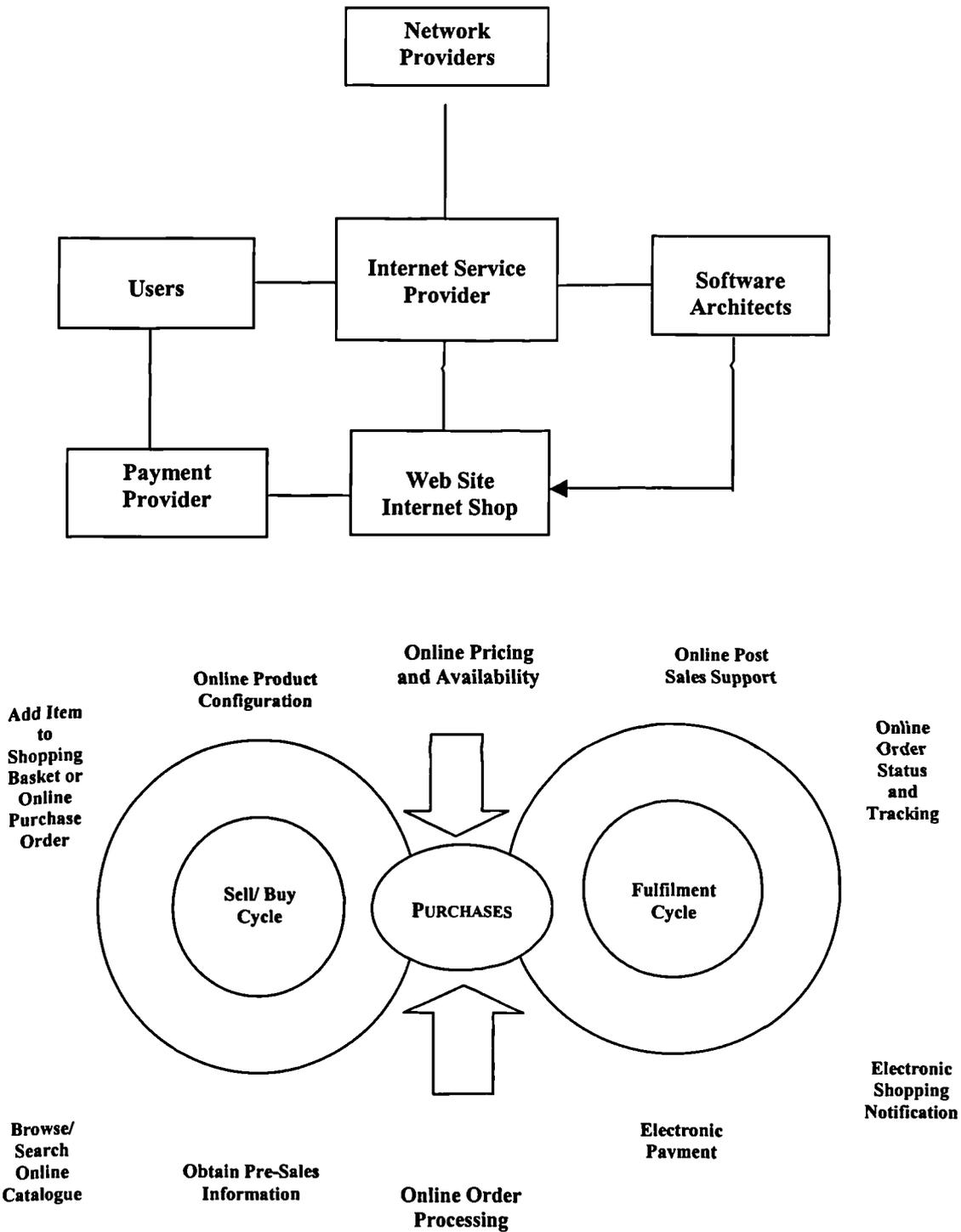
The above discussion is significant not least, because it has an important bearing on certain compliance advantage strategies but also it is fundamental to the proposal discussed later.

- **How It Works - A Typical Transaction**

Before embarking on the discussion of the proposal, an explanation of a typical Internet transaction would be useful. 'Kate', sitting at her computer having just logged on to the Internet. She logs in using a computer and modem to an ISP, which charges her £16 per month for anytime access. The ISP essentially acts as a retailer: it buys bandwidth from a wholesaler of bandwidth (Network Provider), typically a telecommunications company, and resells it in the form of Internet connections, often with a range of value added services.

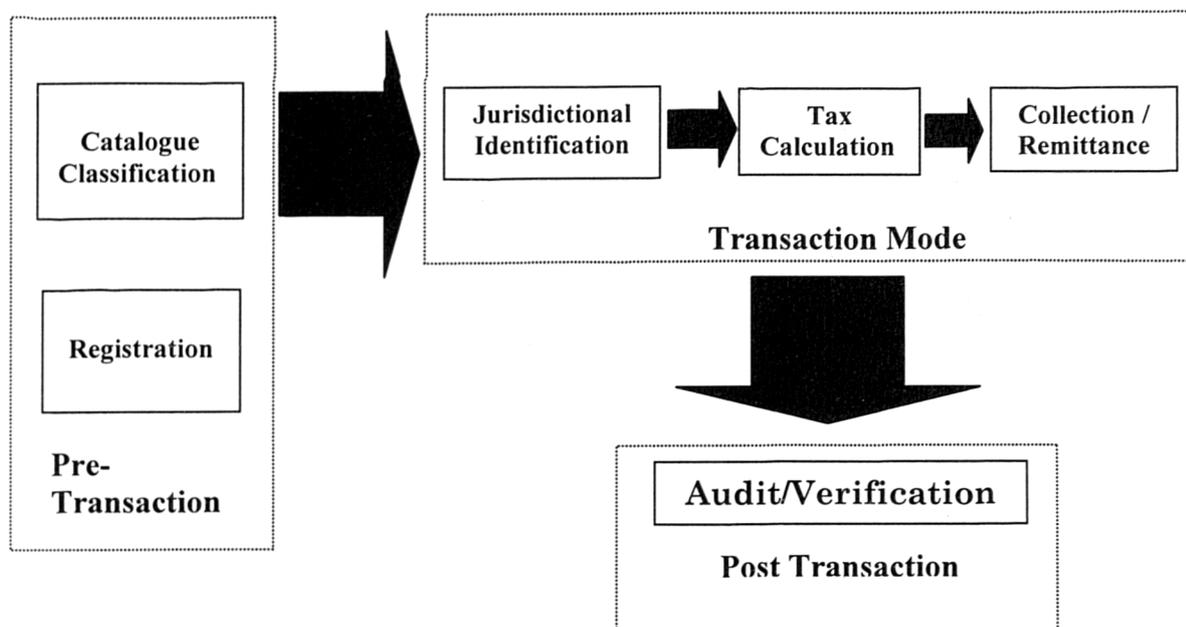
- **Typical Transaction**

'Kate' had a list of CDs she wanted to buy, and having checked the UK and Internet prices, she understood that she would save about £20 from buying them on the Internet. She typed in the address of the web site, *www.cheapmusic.com*, and in a few moments, the details of that site, generally combination of text and pictures, were being loaded on her computer. The site contains details of thousands of commercially available CDs; on many, 'soundbites' can be played as teasers to buy. A decision to purchase the CDs (producers of CDs are content providers in the architecture) was effected using a couple of analogies from the supermarket world, the 'shopping trolley,' (revocable commitment to buy) and 'check out'. Asked for her credit card details 'Kate' used her '*Goodwest Bank Visa* credit card' (Payment Providers: *Goodwest bank*, Payment System Provider: *Visa*), where the flow of funds would be similar to conventional credit card transactions. The website presented 'Kate' with options for delivery, typically ranging from conventional mail to digital download of the songs.



The importance of this architecture is two fold *first*, the Internet causes disintermediation, that is intermediaries in the physical environment that have been effective for collection of the taxes on consumption occurring in a given jurisdiction have disappeared in the virtual world. The effect of which is the fragmentation of economic activity, so much so that it becomes difficult to establish where, in jurisdictional terms, activities are being carried on and by which legal persons. This is not

just a question of anonymity, although that is certainly of administrative significance, but is a question of the diminished importance of location in connection with transactions and need for the parties to know each other's identities. The above architecture shows that there is possibility of re-creating the missing *intermediary*, who can act as tax collector. This new intermediary can be financial institutions such as the (credit card) or Internet service providers (ISP) and can effectively act as surrogate governmental collectors of tax. *Secondly*, from a taxation perspective, it is useful to re-visit Internet and e-commerce environment where the logical model of physical environment of collection of taxes would be required to be implemented for proper collection of consumption taxes.



## 10.2 A PROPOSAL: SUMMARY STATEMENT

After reviewing options with regard collection of consumption, tax the proposal would utilise the ISPs as a responsible authority for calculating, collecting and paying of taxes. ISPs are easily identifiable hence participating; States and Local governments would be able to enter into contracts with them to operate the tax administration. The ISPs would also be responsible for receiving required information on transactions from a seller and providing software for determining the taxability of a transaction, the appropriate tax rate, and the tax due. The proposal would:

### A. REQUIREMENTS

- Involve state of the art e-commerce technology applied to tax calculation, reporting, and payment process.
- Utilise ISP (or any other financial intermediary under a fall back situation) being required to undertake such a role with a profit incentive. Once the consumer approved

a transaction (including the sales tax or VAT), the ISP together with the relevant seller website would perform the tax calculation, collection and clearing process.

- Provide jurisdictional verification, to be determined by Digital certificate and assisting to the maintenance of privacy of consumers by minimizing the disclosure of personal information for tax collection purposes.
- All States and local governments would utilise uniform, definitions of tangible and digital products and services
- Development of tax compliance software to determine the consumption tax due on each sale. This system would work based on information of the product being sold; the taxing jurisdiction of the purchaser; the registered status of the purchaser. Both e-commerce sellers and ISP would have to use this software.
- Real-time calculation of tax to be based on simple inputs. Tax authorities must all make information on tax rates readily available in a standard form, and must give notice of changes.
- Invoicing standards- global agreement on standard invoice details and layout, including electronic invoices.

**B. CHARACTERISTICS AND BENEFITS**

- Maintenance the database of uniform product classification. Sellers would access the database to retrieve the applicable rate, but preferably would integrate the database into their systems or access the information online in real time.
- Substantially reduce the overall burden on consumers by radically simplifying state and local tax systems, inter-State standardization and simplification of certain key features of consumption tax systems, and this includes harmonized sales/use tax rate per State (keeping US states in mind). The nexus rules should be rationalized into a standardized set of rules where all taxable transactions would be treated equally, i.e., there would be a mechanism for all vendors to collect taxes that are assessed and due, and reducing the aggregate collection costs of all transactions, the benefit of which is intended to all consumers, whether or not they make purchases on the Internet
- Provide a destination based simple and equitable tax system that would impose equal obligations and costs on all sellers, local or remote, regardless of sales channel or technology utilized.
- Development of relevant methodology for auditing the tax transactions. The seller would be subject only to a periodic 'system check,' sufficient to ensure that the appropriate information is passed to and received from the ISP.
- The costs of building the system would be borne by the taxing authorities. The cost of development of the software and creation of the Database would share between the different countries calculated in proportion to the Internet usage of the population. Similarly, the deployment and maintenance costs would be apportioned to revenue agencies according to usage.

C. LIMITATIONS

- Minimising the frequency of tax rate changes and preventing countries from unilaterally making changes in the product classification, exemption definition or sourcing rules.
- Rationalisation of 'nexus' into a standardized set of rules where all taxable transactions would be treated equally, would require the political will to overturn *Quill*.

D. SOME FURTHER ISSUES: US SALES TAX

The threshold issues in deciding whether a particular seller of goods or services is subject to sales tax in State A are, first, does State A have the authority to require the seller to pay the tax,<sup>1</sup> and secondly, is the sale one that is subject to tax under the particular regime. In the US, the principal limitations on the states' ability to tax derive from the Commerce Clause and Due Process Clause of the Federal Constitution. The distinction between Commerce Clause limitations and due process limitations is important in that Congress has the power to overrule the first, but not the second. Over the past several decades, a substantial body of law has developed defining the constitutional limits on a state's ability to tax remote vendors, principally in the mail order context. The current U.S. sales/use tax system is governed by the nexus standard as clarified by the Supreme Court in *Quill*.<sup>2</sup> In *Quill*, the Supreme Court held that the Commerce Clause of the Constitution bars a state from burdening interstate commerce by imposing a sales or use tax collection responsibility on a vendor unless that vendor has a physical presence within the state. Accordingly, out-of-state vendors who do not have a physical presence within a state may make sales to an in-state consumer without incurring a responsibility to collect and remit sales or use taxes to the taxing jurisdiction. The U.S. Supreme Court ruled that physical presence is not required for Due Process Clause 'minimum contacts' analysis, but retained the *Bellas Hess*<sup>3</sup> bright-line rule requiring physical presence for Commerce Clause purposes based on the value of certainty and *stare decisis* in fostering business investment. However, the *Quill* court implicitly questioned whether the physical presence test was in fact the right test, and explicitly invited Congress to overrule its holding if it deemed it desirable. Although it is the responsibility of the consumer to self-assess and remit use tax with the appropriate jurisdiction. However there is virtually no compliance or enforcement of this system. This also may be in part due to the complexity that is inherent in sales and use tax system. There are more than 6,000 overlapping state and local jurisdictions, which may impose sales/use taxes. Each jurisdiction is constitutionally empowered to determine both the sales/use tax rate that will apply within its borders, and which transactions it will tax. As noted by the Supreme Court in *Quill*, this has led to an increasingly complicated 'quagmire' of

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<sup>1</sup> Note that even if the seller is not required to pay the tax, the transaction may still be, at least in theory, taxable. If the product purchased is consumed in the state levying the tax, the consumer may be required to pay a use tax on the value or cost of that product. Most states and localities make no effort to enforce their use tax laws on consumer purchases of this type.

<sup>2</sup> *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S.Ct. 1904

<sup>3</sup> 386 U.S. 753 (1967).

multiple sales/use tax rates, multiple characterizations of the same transaction, and multiple audits of the same transaction by multiple authorities.<sup>4</sup>

Unless Congress acts, the *Quill* decision mean that states simply cannot constitutionally obtain jurisdiction over remote e-commerce. Congress recognising the special nature of e-commerce sales could reverse *Quill* and eliminate the requirement for physical presence to establish substantial nexus under the Commerce Clause. The question would then be how to articulate and interpret the new standard. The most obvious would be to preserve the overall *Complete Auto*<sup>5</sup> analysis, but to declare that the substantial nexus prong of that analysis would be satisfied if the Due Process Clause is satisfied, *i.e.*, that for purposes of requiring a remote vendor to collect sales tax on a sale into a state, there would substantial nexus if the vendor purposefully directed its activity toward that state. That approach, although appealing in its simplicity, has significant problems. From the state's point of view, this would give them the right to require a much larger category of remote sellers to collect their sales tax, but in the absence of other tools, it would give them no practical way to actually enforce that right. From the e-commerce seller's point of view, this would cause greater compliance problems. Having the obligation to collect sales tax from almost any purchaser, it would require that the seller would have to determine how much to collect and whom to send it to among thousands of different taxing authorities. However, nexus issues are inherently intractable, involving as they do fundamental fairness concerns and deep constitutional principles. It would be require more of the political will rather than legal to make any changes. Many commentators also believe that the current system of sales/use taxation must be radically simplified if the current nexus standard is to be altered<sup>6</sup>. A system, which is radically simplified, would potentially lead to better compliance and an increased revenue flow to state and local government as a result. Additionally, a radically simplified system would reduce the cost to state and local governments of administration and enforcement. Further, a simplified system would benefit all vendors because it would reduce their cost of compliance. Development of such uniform process of classification would not be too difficult as there have been already steps taken through Streamlined Sales Tax System (SSTS). The goal of SSTS is to develop a more simple, uniform, and fair system of state sales and use taxation that significantly reduces the burden imposed on retailers, preserves state and local sovereignty, and enhances the ability of U.S. firms to compete in the global and information economy. Although the proposal is voluntary, retains current law with regard to 'nexus', however the SSTS is step in the right direction.

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4 Ibid

5 Under the Commerce Clause, a state tax on interstate commerce must meet four criteria in order to be upheld as valid: (1) the tax must be applied to an activity that has substantial nexus with the state;(2) the tax must be fairly apportioned to activities carried on by the taxpayer in the state; (3) the tax must not discriminate against interstate commerce; and (4) the tax must be fairly related to services provided by the state. *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977)

6 Proposals Submitted to Advisory Commission on Electronic Commerce. See "Establishing a Framework to Evaluate E-Commerce Tax Policy Options" by Rich Prem of Deloitte & Touche, San Francisco; Hal Varian and Alan Auerbach of the University of California-Berkeley; Austan Goolsbee, the University of Chicago; Annette Nellen, San Jose State University; Scot Grierson, Deloitte & Touche, Costa Mesa and Ed Jajeh and Tara Bradford of Deloitte & Touche, San Francisco. The report was based on issues and ideas raised in an "E-Commerce Taxation Roundtable" on October 1, 1999 at UC-Berkeley.

Radical simplification is, however, only the beginning to dealing with all of the issues regarding the sales and use tax system. If radical simplification could be achieved then there could be standardization and clarification of the nexus rules, i.e.; all taxable transactions could be treated equally regardless of the medium used for purchase. Currently the nexus standard, as upheld by the Supreme Court, required that a vendor must have 'substantial nexus' with a state before the state can impose the obligation of the collection of sales tax. The definition of substantial nexus and what level of activity within a state rises to the level of substantial nexus is the subject of much controversy and had been widely litigated. The nexus rules should be rationalized into a standardized set of rules where all taxable transactions would be treated equally. There appears to be a general consensus that it would necessary to give the states the ability to require a broader group of remote sellers to participate in the collection and/or enforcement of the existing system of sales and use taxes if we are to deal effectively with the issues of base erosion and discrimination. It is clear that, in reality, any effort to give the state and local tax authorities the power to require more remote sellers to join their tax system must be coupled with efforts to significantly simplify the process and lighten the compliance burden on those sellers. This would require the cooperation of Congress, the state and local tax authorities and industry groups representing the various business interests involved, electronic, and otherwise.

### **10.3 THE PROPOSAL: DESCRIPTION**

In theory, the burden of the sales/use tax or VAT is passed on to the consumer. In practice, it is depended on the particular good or service that is sold. *If demand is highly inelastic* or if the reach of the tax is sufficiently broad to apply to the consumer's alternatives, it would be passed on. On the other hand, where the consumer could purchase the same good or service through other means that avoid the tax, then the seller who was subject to the tax would almost certainly have to absorb the cost. The assumption that the tax would be or should be passed on to the consumer, is critical to understanding the jurisdictional issues that arise from sales into a state from a remote source and, in particular, to understanding why it important to achieve neutrality. Virtually all concerned parties agree that state taxes on e-commerce should maintain competitive equality between similarly situated economic actors. The principle of tax competitive equality suggests that those who provide goods or services in e-commerce should be taxed no differently than those who provide goods or services in conventional commerce. It is a principle of consumption tax that state taxes on e-commerce should be uniform, including uniform standards and definitions. Simultaneously the taxes on e-commerce should also be administrable, so that compliance burdens are not excessive and the costs of administration are reasonable. The basic economic activities of governments are to raise and re-distribute revenues and to provide public services. If these activities could be thought as the 'business of government', then just as private businesses are reaping efficiency gains from the Internet and e-commerce, so too could governments increase the efficiency of what it does as a business. The governments should also think about how to use e-commerce to improve services to citizens. The OECD back in 1998 recognised that the e-commerce technologies could also be used for administering tax laws, collecting tax revenues

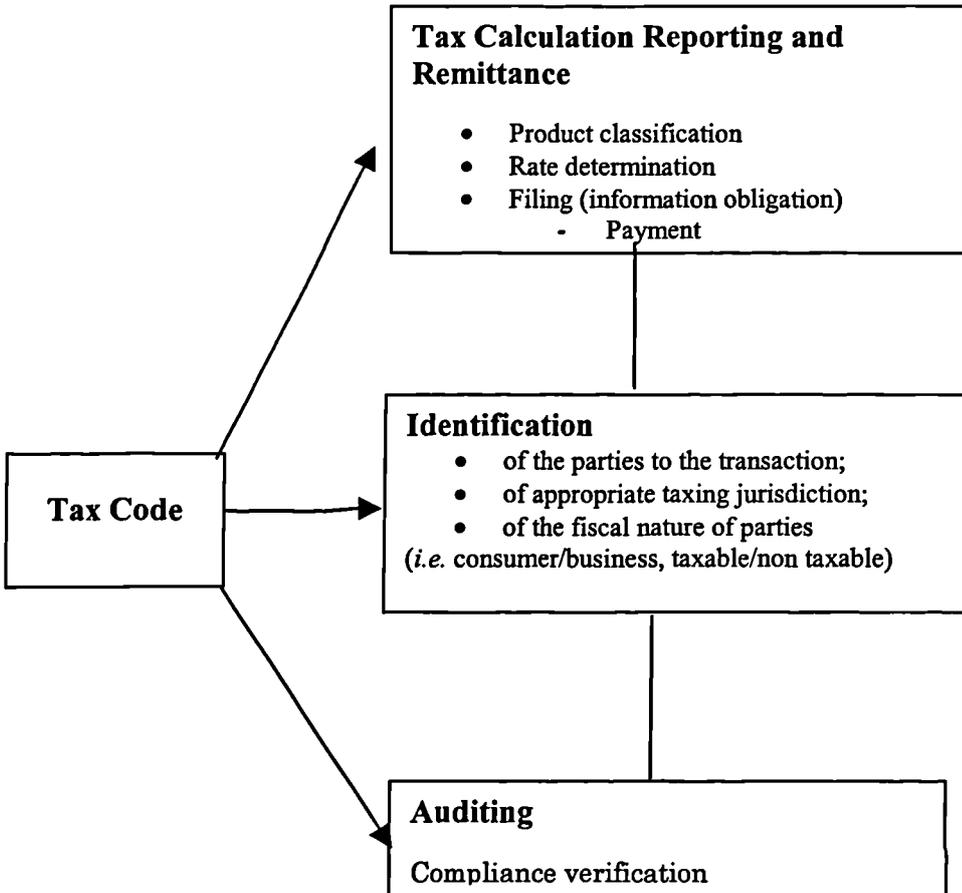
and identified some opportunities offered by the technologies include:

- revolutionising communications between tax authorities and taxpayers and enhancing access to information for taxpayers to help them in complying with their tax obligations;
- tax registration and filing requirements could be simplified;
- electronic assessment and collection of tax can become the norm rather than the exception; and
- easier, quicker, more secure ways of paying taxes and of obtaining tax refunds will be facilitated.

Governments were urged to seize the opportunities offered by the new communication technologies to improve the service they provide to taxpayers, to reduce the cost of complying with tax rules and to use more effectively the resources devoted to the collection of taxes. Though it did not provide any guideline to what part of Internet or what technology could be used it was effectively recognised that it would be ultimately a combination of technology and principles, which would provide the answer to tax collection complexities. What must a solution provide?

- Identification of the parties to the transaction (the status of the customer as a business or a consumer).
- Identify the jurisdiction, which is entitled to tax the sale: this would be the state, which has the appropriate connection with the customer, probably the state where the customer resides but ideally the state where consumption takes place.
- Identify the type of product that is being sold, so that the correct tax rate and other tax rules can be applied.
- Tax calculation-product classification and rate determination.
- Reporting and remitting of taxes to the appropriate government authority and
- Compliance verification- proving to an auditor that taxes was paid.

This is represented in the following diagram:



The system should also provide individuals and businesses an ‘architecture of trust’<sup>7</sup> between them which could comprise<sup>8</sup> of:

- authentication to confirm the identity of individuals;
- authorization, to ensure an individual is permitted to conduct a particular function;
- privacy, to ensure others cannot discern what exchanges are taking place;
- integrity, to ensure the transmission is not corrupted; and
- non-repudiation, to ensure the liability and accountability of the sender.

As a matter of pure tax policy, the state has a legitimate interest in administering a tax system that

- is fair to those who are subject to it;
- minimizes any distortion of economic decision making within the economy;
- does not require undue effort by either the tax collector or the taxpayer to interpret and administer; and
- raises a sufficient amount of revenue to carry out the legitimate functions of government.

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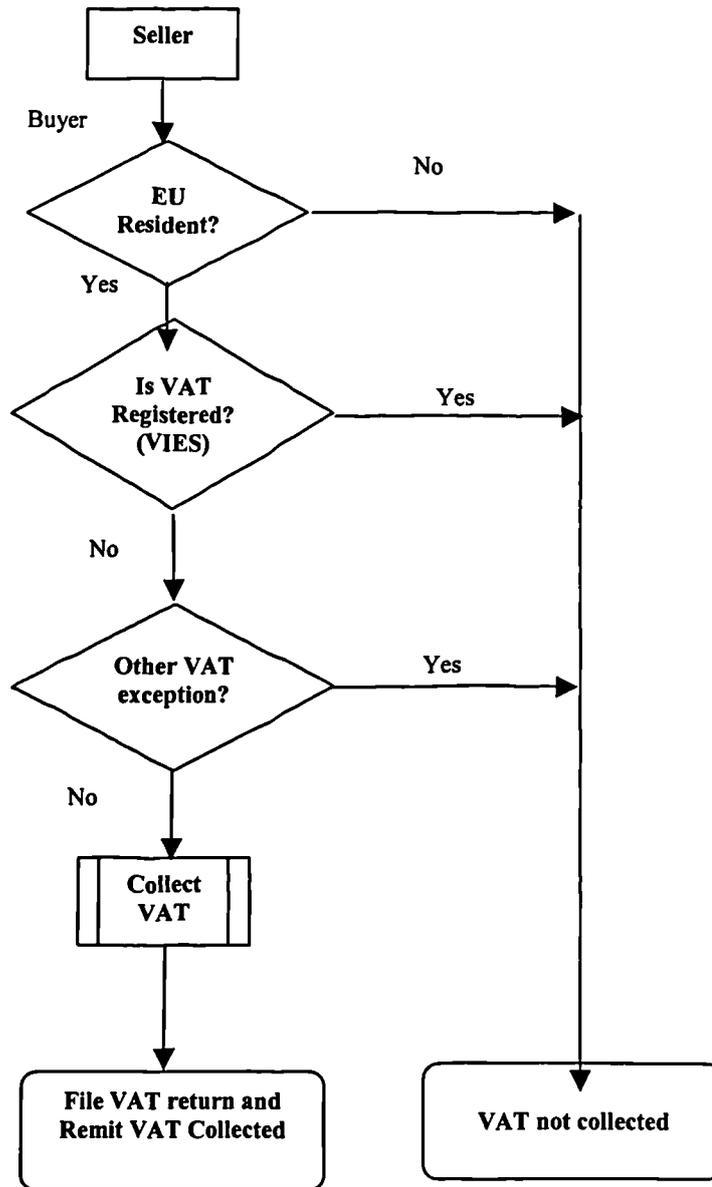
<sup>7</sup> Lessig called this an ‘architecture of trust’

<sup>8</sup> Gail L. Grant, *Understanding Digital Signatures*, at p 14, as excerpted in Lessig, at p 40.

Generally, all four of these goals are best met through a tax system that has as broad a base as possible and that has effective, but socially acceptable methods of enforcement. The initial focus is on VAT and EU Digital VAT. The EU has already committed itself to tax digital transaction without an effectively describing the possible mode of collection. Assuming the worst-case scenario from a VAT collection and enforcement perspective, a private consumer within the EU downloads a virtual good, e.g. software programme, from a server located in a Caribbean low tax jurisdiction. Payment is made using a non-accounted payment system.

Before implementing any solution for such cases it is necessary to define what the tax authorities need to ensure before taxation in the related EU Member State. The answer is quite simple: it is the properly calculated tax paid to the Member State where the transaction is taxable requiring the gathering of information and the collection of VAT from residents outside the EU. The other three requirements are, to learn that a (taxable) transaction has taken place, to obtain the information necessary to determine the Member State to apply the appropriate tax rate in which the transaction is taxable and to gather the information to properly calculate the tax due. The required information depends to a great deal on the implementation of the places of supply principle. However, the EU Directive on Digital sales provided that there are two distinct places of supply for digital deliveries in accordance with the varying tax status and location of the recipient. Accordingly, this has created the necessity for identifying the location of supplier. There is difference between taxation of digital transactions originating either from without or within the EU.

The following diagram shows a common workflow of an e-commerce transaction.



This workflow diagram based on the above mentioned elements of indirect taxation adds further issues particularly relevant for imposing EU VAT on digital sales:

- **EU Resident:** Currently it is not technologically possible to identify with certainty the geographical location of the buyers
- **Registration status of the customer for VAT purpose:** The tax status of the customer to determine whether the recipient is registered for VAT purposes or is a private consumer. This however could be solved by modernisation of the VIES system, which the EU Commission has already initiated and it is now available to the traders at the time and place required. However, this does not ensure that the buyer is who he claims to be.
- **Other VAT exceptions:** Sellers will not be required to collect VAT, under these rules, if their only activity in the EU is the supply of these services, and if the annual sales

in EU is below the threshold. If non- EU seller sells only to VAT registered business the seller will not be required to register for VAT.

- The tax rate: There is a potential issue to be addressed concerning the possibilities of different tax rates applying to ostensibly similar goods and services.

In the example scenario mentioned above only two parties are involved in the transaction, the vendor, or rather his server, and the customer and the ISP of the customer. There is a lack of intermediaries such as wholesalers and middlemen. The central element in the proposed new system would be the recreation of 'intermediaries', which in this scenario is the ISP. Connections to an ISP are typically made through a local point of presence ('POP'), commonly through a local or toll-free call utilizing telecommunications facilities acquired from other companies. Since ISPs know the identity of the user, and the characteristic nature of Internet requires the ISP to copy all Internet *communications*, including e-commerce transactions, for subsequent transmission to the user, it is possible they could take the responsibility of keeping track of all financial transactions a particular user makes and act as tax collector. In order the proposal work effectively all participating States and local governments would enter into contracts with one or more ISPs to operate the tax administration system. The seller and his access provider reside outside a particular jurisdiction (in the above example outside EU) hence they therefore could not be subject to public duties such as the collection of taxes. A gain it wouldn't be feasible to enter into contracts with the sellers' ISPs as theoretically there can be 'N' number of ISPs and concluding mutual agreements with them would not even be a theoretical solution. This leaves only the buyers' ISP who could be made liable for the collection of taxes.

Primarily the proposal is aimed to be as simple as possible. The proposal is coherent with the conditions and principles laid down by the OECD Ottawa Taxation Framework Conditions. The system is simple to administer, it would not require any fundamental change to the tax principles, and neither does it contradict any established tax principles. The proposal is consistent with the view that tax policies should be respectful of the fiscal sovereignty of a Nation State. The system only applies the 'applicable tax' for the 'appropriate' jurisdiction. It is consistent with the beliefs that governments should keep the tax and administrative burden on consumers and businesses as low as possible. Hence the proposal, utilizes the available technology at its disposal, based primarily on four basic elements: an ISP, digital certificate, a database of universal product classification, and software for calculation of the tax. It provides structure, which facilitates the collection and remittance of sales tax or VATS that is due, but currently goes uncollected. ISPs would not impose taxes; they only execute the collection procedure based upon a set of rules and guidelines outlined by revenue agencies.

The collection of sales taxes on remote consumer purchases is not a new tax. The responsibility to pay sales/use tax had always been directed by guidelines and they have never been nullified by court decisions or by federal laws. Similarly from the perspective of EU VAT on digital sales, it is the EU Directive that provides the law and rules to collect the tax on digital sales. The proposal only provides the method and the means to collect the taxes.

E-commerce changed the paradigm under which consumption taxes had been established; selling of intangible goods over the Internet is a relatively new phenomenon for traditional consumption tax structures. Hence, it is more out the necessity that the governments should re-define the tax bases and provide uniform categorizing goods and services that could facilitate a process of coordination. That is, because the e-commerce marketplace is so integrated, the policy toward handling one issue, even within the national context, has implications for the policy set that is available to policymakers on other issues. The proposal keeping in mind the global reach of e-commerce, would implement the uniform product classification not only within boundaries but also across-boundaries. Further, such an activity should also be carried out under the auspicious of a world trade organisation. The benefit of involving a world organisation would be *firstly*, to provide consistency, and *secondly*, it would encourage the much-needed involvement of developing countries. Such an effort could also initiate cooperation between the developed and developing countries in the broader area of tax policies. The process of uniform product classification would ultimately provide 'tax neutrality'. For example, following the EU approach if all e-commerce transactions were services, they all should be tax the same way. To do otherwise would imply inconsistent VAT treatment of electronic transactions within and outside countries. The approach the EU had taken effectively 'harmonizes up' tax rates in order to maintain tax neutrality. The system would levy applicable taxes to purchases regardless of the domain of the seller. In effect, due to the uniform product classification, the system would have a universal acceptance. Hence, purchases from the local shop would receive similar tax treatment to purchases made through a catalogue or by e-commerce. From a sales tax or VAT perspective, this means certain socio-economic groups would not receive unfavourable treatment since they do not have Internet access, or they live in certain geographic location.

Why ISPs and why not the financial intermediaries like credit card companies itself is made responsible for collection of taxes. Financial intermediaries do play important role not only in e-commerce transactions but also in all other forms of remote sell. It has been proposed 'as a way out'. The OECD Consumption Tax TAG and the WP 9 Sub-group have suggested that credit card companies could be enlisted to collect the consumption taxes. One of the reasons for this suggestion was that financial institutions already facilitate the financial transaction between the business and the consumer. There are advantages to this view:

- Over the long run, it is expected that most of the financial intermediation on the internet would be in the hands of institutions that are of sufficient size and sophistication to handle the complexities of offering credit/debit services in what must be the most complex marketplace in history, hence administering a system for the collection of sales tax or VAT could fit fairly naturally into their systems.
- Reliability, respectability, and creditworthiness would be a sine qua non for any successful participant in financial intermediation on the Internet. Thus, a system in which they play a leading role would be more stable and predictable, with comparative lower compliance costs for the tax authorities.

- There is likely to be sufficient nexus between such institutions and the states whose tax they assist to collect; an institution that extends credit to residents of a state will undoubtedly use the resources, including the courts, of that state as part of its own collection and dispute resolution processes, which predictable should work quite adequately for a destination based consumption tax system.

However, there are also disadvantages. A number of financial institutions or credit card companies have already indicated that they do not collect the necessary data to perform the tax collection task. Although financial institutions are in a better position than the seller to know the place of consumption or purchase data that is relevant to collecting the tax on a particular transaction, but they are in an inferior position with respect to knowing what taxable category the product being sold falls into. They would have to be in a position to rely on data given them by either the buyer or seller in determining whether a particular sale is entitled to exemption or a lower rate of tax in the relevant jurisdiction. In fact, financial institutions claim that they are not engaged in the business of selling goods and taxable services and therefore are not equipped to collect and remit consumption taxes. Putting the financial intermediary in the position of tax collector in a credit extension context increases their credit risk with respect to the taxes collected. Compensating them for that risk will be another cost of such a system.

There is also further concern about privacy. A customer's expectation that a financial institution will respect the privacy and confidentiality of their business relationship is fundamental to the relationship between an institution and its customer. To the extent that a card issuer provides or verifies personal information, such as a residential address to a merchant or to anyone else for a purpose unrelated to approval or disapproval of the credit card transaction, raises privacy and confidentiality concerns. A cardholder has a reasonable expectation of privacy in the information that it furnishes to card issuers for obtaining credit. Privacy protections of cardholders' personal information are contained in privacy laws in the United States, the European Union, and in other major jurisdictions around the world. The privacy provisions differ considerably from country to country, and there are restrictions on transferring personal data from the European Union to other countries. A card issuer's access of its records to obtain personal information about a cardholder in order to disclose or verify such information with a merchant could potentially expose the card issuer to liability. An important component of the card issuer-cardholder relationship is the reassurance given to the cardholder that the institution will safeguard personal information in strict confidence. This confidentiality promise is written into many card agreements and policy statements published on the Internet and elsewhere to inform customers of the institution's policy. Such assurances are essential to customer confidence, particularly in the case of on-line transactions, where customers concerns about privacy are especially acute. Credit card issuers are sensitive to consumer fears about revealing their personal and confidential information over the Internet. The public perception that financial institutions to online merchants would release personal information such as a cardholder's place of residence raises industry concerns that this could seriously erode consumer confidence, compromises confidentiality, and could potentially expose them to legal liabilities.

However, even if all the issuers could be drafted as tax collectors, there is always the possibility that credit cards would be replaced by unaccounted digital cash in the future as the principle mean of financial transaction, which would progressively diminish their usefulness in establishing the location of consumers. Digital cash systems are more than a hypothetical possibility. MasterCard and Mondex, for example, have been testing 'smart cards' for several years; and in Denmark, a consortium of banking, utility, and transport companies has announced a card that would replace coins and small bills<sup>9</sup>. A tax system based on credit cards would only exacerbate the trend towards digital cash: the anonymity it offers would become immediately more attractive if governments seek to keep tabs on consumers through their credit transactions. Finally, there is always a psychological barrier particularly in consumers accepting credit card companies and tax agencies working together for collecting taxes.

It is worth considering that these alternate intermediaries have no obligation to serve as tax collectors or even transaction reporters. While seeking a centralized pressure point on which to impose collection or reporting obligations is attractive to the taxing agencies, however it seems unlikely that financial intermediaries would cooperate. For example, rewriting the entire credit card industry's software and billing systems to support a tax reporting, collecting and remittance system would be far too costly to implement. Further making use of credit card companies would not provide any collateral benefit for the growth of Internet and hence e-commerce. The growth of Internet is directly proportional to the cost of development of its infrastructure and cost of accessing Internet. In fact, the more central the player is in the e-commerce arena, and therefore the more attractive as a collection point they would appear to tax agencies. It would therefore be entirely logical to utilize the ISPs as they perform a more central function than their financial counterpart. Although working out the system that works well from a compliance point of view while not giving the ISPs an overly burdensome duty of inquiry into the bona fides of the information provided them would be a delicate task.

Developing countries would benefit in encouraging an infrastructure that supports e-commerce market conditions. High Internet access rates, low penetration of electronic means of payment (such as credit, debit, or Smart cards), and cumbersome delivery systems are primary obstacles to the growth of e-commerce in such countries. In such a situation making the ISPs accountable and providing them with financial incentives would encourage them to reduce the cost of Internet access. The number of ISPs operating in most developing countries is quite small hence entering into contact with them would be less burdensome. As most of the technological elements would be developed collectively this would ensure the reliability and performance capability of the technology. Again, it is important in developing countries that do not have the technology or infrastructure to create such a trustworthy and trusted end-to-end systems.

Developing countries often lack well-designed tax policies that are translated into clear legislation and are administratively feasible. This proposal sets out the strategy for encouraging an international cooperation and for developing greater coherence between interested international organizations, it

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<sup>9</sup> Elinor Harris Solomon, *Virtual Money* (New York: Oxford University Press, 1997), at 70

aims to utilize the on going technological advancements and the fundamental infrastructure that is correlated with the development of internet. This collective effort will not unduly burden the developing countries and will provide the much need mechanism for tax collection.

#### **10.4 THE PROPOSAL: ANALYSIS**

The system as proposed is to work in two stages. The first stage would involve identification of the parties to the transaction. The ISPs seller's website and identification technologies would act in combination in order to:

- independently verify the location of the consumer,
- identify if it is a taxable sale to a consumer or an exempt sale to business (or to a non-profit organization or government)
- utilise supportive infrastructure allowing controlled access to the information relevant to taxation

In the second stage, the ISP would be responsible for receiving required information on transactions from a seller and would provide software for determining the taxability of a transaction, the appropriate state and local tax rate, and the tax due. The system would be supported by a universal product classification database and all States and local governments would utilize the same definitions of tangible and digital products and services based on that classification. The sellers would be made aware of tax information at the time of the sale, so that the information on tax due would be available to the customer before completion of the transaction. The credit card companies and other electronic payment processors would transfer the tax due to the ISPs for transmittal to the respective governments.

##### **10.4.1 IDENTIFYING THE LOCATION OF CONSUMPTION FOR TAX PURPOSES**

###### **A. Digital certificates**

A prerequisite to any tax is identifying the taxpayers who are participating in an international transaction as well the geographic location of these parties. However, the decentralized nature of the Internet frustrates attempts by e-commerce businesses to identify the location of these parties. The similar problem would be faced by the ISPs when acting as tax collectors. Although they would be aware of the location of the consumer, however they would require verifying it beyond any reasonable doubt. As well as finding out which jurisdiction the customer should be linked to it would be important to find out whether a customer is a business or a consumer.

Digital certificates are suggested as one mechanism that would assist in this process. Digital certificates (also known as electronic credentials or digital IDs) are digital documents attesting to the binding of a public key to an individual or entity. They allow verification of the claim that a given public key does

in fact belong to a given individual or entity.<sup>10</sup> Although this technology has been in existence for sometime now but it is not in widespread use. Such technology is mainly used on 'commerce servers'. These server IDs allow web sites to identify themselves to users and to encrypt transactions with their visitors. This kind of digital certificate helps the host server's users know that they are communicating with a particular host and not an impostor.

Digital certificates go hand in hand with digital signatures. Digital signatures work on key pairs, one of which is public and the other private. The private key is used to encrypt a document while the public key is used to decipher it. The private key needs to be protected to preserve its value. The private key can be stored in various ways. For example, it can be stored on the user's hard disk, on removable media (such as a floppy disk), or on a smart card or other 'smart device'. These digital signatures are usually used with digital certificates to authenticate the attestation in a certificate. They could also be used to digitally sign a VAT invoice so that a business purchaser has an electronic invoice that could form the basis of claiming an input tax credit for VAT paid. The digital certificate could be registered with a so-called 'trusted third party' that could be a government agency or even a private company; the trusted third party would act as a kind of bonding agency to ensure the veracity and accuracy of information given out by the digital certificates<sup>11</sup>.

A high degree of international harmonisation would be necessary if any scaleable and reliable PKI is to be used by the ISPs for tax collection purposes. Both the OECD and UNICITRAL have addressed the issue of cryptography<sup>12</sup>. The OECD Guidelines advanced the key principles to govern the emerging PKI as trust, choice, market driven, industry standards, clear liability, and the promotion of international trade. UNICITRAL advanced a full Model Law on Electronic Signatures, and this gives a developed legal framework for certificate service provision within an internationally operative PKI<sup>13</sup>. Article 7 of the Model Law on e-commerce paved the way for electronic signatures<sup>14</sup>; it adopted a *de facto* two level definition of electronic signatures, and extensively provides for a PKI system of digital signatures through a three party conceptualisation of the duties and responsibilities of parties in the

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10 A more elaborate definition indicates: "A digital certificate is an electronic "credit card" that establishes your credentials when doing business or other transactions on the Web. It is issued by a certification authority (CA). It contains your name, a serial number, expiration dates, a copy of the certificate holder's public key (used for encrypting and decrypting messages and digital signatures), and the digital signature of the certificate-issuing authority so that a recipient can verify that the certificate is real. Some digital certificates conform to a standard, X.509. Digital certificates can be kept in registries so that authenticated users can look up other users' public keys."

Whatis.com, located at <<http://www.whatis.com/digitace.htm>>.

11 For a discussion of trusted third parties in the context of digital signatures, see Brian W. Smith & Paul S. Tufaro, *To Certify or Not to Certify? The OCC Opens the Door to Digital Signature Certification*, 24 OHIO NORTH. UNIV. L. REV. 813 (1998) (noting that certification authorities are "essential to the development of electronic commerce and electronic banking"); A. Michael Fromkin, *Innovation and the Information Environment, The Essential Role of Trusted Third Parties in Electronic Commerce*, 75 Or. L. Rev. 49 (1996)

12 OECD Guidelines on Cryptographic Policy, and UNICITRAL Model Law on Electronic Signatures

13 Though purporting to be technology neutral, the Model Law unquestionably works towards a PKI implementation of digital signatures: para 14, and para 21.

14 Art 7, Model Law on Electronic Commerce

context of electronic signatures<sup>15</sup>. The European Commission has also taken initiatives<sup>16</sup> and in relation to electronic signatures, the provision is the Directive on Electronic Signatures<sup>17</sup>.

Regulatory and legislative initiatives to build the PKI, at the level of UNITRAL, OECD, the European Union, and the legislative and policy work of the UK, are all promoting the network PKI. It also provides important contribution to the development of the previously discussed 'architecture of trust'. The emergence of the infrastructure is, of course, still only in its early stages and period as to when such network architecture would be in place is difficult to predict<sup>18</sup>. However, through the regulatory structure put in place, and from the initial structure of private sector certificate service providers (CSP) entering into the market, it would appear that the network of cross-certifying CSPs would develop quite rapidly. For the proposal to work, effectively it would be required to identify whether their customers were consumers or businesses. This is because VAT would need to be applied by suppliers to sales to consumers but not to sales to businesses. Business customers would operate the reverse charge, as they do now. Under the reverse charge system, a business buying certain services and digitised products from abroad pretends that it is selling these items as well as buying them. It then charges VAT on those notional sales, accounts for that VAT and pretends that it had suffered the same VAT on its purchases. The overall effect is the same as if the business had paid VAT on the purchases in the first place.

Some commentators have argued that it would be quite straightforward for suppliers to identify the difference between business customers and consumers, but in fact, it would not. So long as business customers are left to apply VAT to their own purchases, consumers would have a financial incentive to pretend that they were businesses so that suppliers did not impose VAT on them. It would therefore be no use to include a question on an order form, 'Are you a business?' If more subtle questions were designed to check the answer, it would likely to put consumers off: people are not used to being quizzed when they go into shops, and they resent being quizzed when shopping on the Internet<sup>19</sup>. The distinction between consumers and business is not something inherent to Internet technology. However, Digital certificates have the potential to deliver this feature. A certificate includes the following information: identity of certificate service provider; name and details of signatory; validity period; unique certificate number; limitations/exclusion on third party use; details of how key generated; system for protecting signatory private key; details of revocation provisions, details of service hardware and software; and the certificate service provider's own digital signature. The digital signature on the other hand provides the following features: (i) it is uniquely linked to the signatory; (ii) it was created under the control of the signatory; (iii) its integrity is clear; and, (iv) the integrity of the message is clear from the signature.

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15 Murray, Jamie (2003) Public Key Infrastructure Digital Signatures and Systematic Risk (Due for Publication) cited with permission from Author.

16 Directive 1999/93/EC & 2000/31/EC

17 1999/93/EC

18 DTI Consultation on the implementation of the Electronic Signatures Directive, paragraph 13

19 This was recognised in the Consumption Taxation TAG paper, annex II, paragraph 11

It should be noted, however, that in some legal systems, only natural persons might hold certificates and the person in their corporate function may only be distinguishable from the private person using an attribute field. However, such situation could be avoided if the revenue authority in a country, or a trusted third party, certifies businesses as being registered in a particular country or countries for VAT purposes by issuing them digital certificates. If the purchaser presents a digital certificate, the transaction would be relieved from tax. If the purchaser does not present a digital certificate, it would be treated as a consumer, and VAT would apply using the identification techniques, which I am going to discuss below under a fallback situation. In my view, adoption of the use of digital signatures in conjunction with a digital certificate would be able to assist identification process and would be able to provide information such as the location of the user beyond any reasonable doubt.<sup>20</sup> It also would help to determine accountability of a particular transaction, integrity of the documents and records used along with identification of the sale to a consumer or business.

**B. IP Address and Credit Card**

However, in a fall back situation where ISPs are unable to utilize a digital certificate, as an alternative means would be to rely on are IP address, credit card number, credit card billing address, and self-declaration. According to the OECD Consumption TAG, all of these identifiers have some, if not significant, limitations. Internet Protocol (IP) addresses offer potential in that they are an essential part of every access point to the Internet. However, IP systems would seem to offer limited possibilities in terms of securely identifying a consumer with a taxing jurisdiction at the time a transaction takes place. Even the new IPv6 (Internet Protocol version 6) addresses, which have space for much more information than the old IPv4 addresses, would not carry geographical information, in order to include a predictable geographic component, further work required to be carried out. Even then, customers could use 'anonymising' services to hide the geographical information. In a fall back scenario the pseudo-geographic link between IP number and jurisdiction could be potentially significant. Given today's technology, the limited improvement in location technology offered by IP traces appears to be the best available. However, there is a significant reluctance on the part of business to undertake implementation of such systems because of concerns of the lack of commercial necessity limited

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20 Electronic Signatures in Global and National Commerce Act, S. 761, 106th Congress (June 30,2000) (effective October 1, 2000). The legislation permits individuals to use binding electronic signatures for interstate or foreign commerce. A digital signature has been defined as follows: 'A digital signature (not to be confused with a digital certificate) is an electronic rather than a written signature that can be used by someone to authenticate the identity of the sender of a message or of the signer of a document. It can also be used to ensure that the original content of the message or document that has been conveyed is unchanged. Additional benefits to the use of a digital signature are that it is easily transportable, cannot be easily repudiated, cannot be imitated by someone else, and can be automatically time-stamped. A digital signature can be used with any kind of message, whether it is encrypted or not, simply so that the receiver can be sure of the sender's identity and that the message arrived intact. A digital certificate contains the digital signature of the certificate-issuing authority so that anyone can verify that the certificate is real.' Whatis.com, located at <http://www.whatis.com/digitasi.htm>.

utility, costs of implementation and potential for disruption of service in cases of unclear results.

While credit cards are currently the dominant method of payment for goods purchased over the Internet, it is important to note that there have been significant developments towards other payment mechanisms, including digital cash and stored value cards. Alternative payment mechanisms such as digital cash and stored value cards are the second-generation payment systems for many Internet accessible jurisdictions around the world. These payment systems are becoming more widely accepted for e-commerce transactions as new and innovative solutions come to the market place. Credit card systems as currently designed are not much help in identifying jurisdiction. Although as a part of the marketing purposes the credit card issuers are likely to be interested in whether cards were held for business or personal use, however providing such would cause serious customer privacy concern. This would not be a practical option for three reasons:

- Only minimal information about cardholders is passed to suppliers, both in order to reduce the scope for fraud by learning enough about cardholders to impersonate them and because of cardholders' concerns about privacy.
- The status of a cardholder is not computable from the card number. Thus, an additional stage of looking up the status and transmitting it to the supplier would be necessary. While the concept of matching a credit card number to the country of residence was originally thought to have promise, further investigation demonstrated that there was no correlation between numerical Bank Identification Number to geography.
- The determined evader of VAT would simply apply for a new card, telling the card issuer that it was for business use, even if it was in fact for personal use.

It would further raise some troubling privacy issues. Currently, governments generally do not have access to credit card company data unless a particular cardholder is suspected of committing a crime. The use of such data for tax collection purposes would potentially put a detailed record of a person's buying habits in the hand of government authorities on a regular basis, without the normal judicial protections. The possible abuses of that information are enormous and it is doubtful whether many individuals would easily accept the unprecedented invasion of their privacy. None of the two foregoing would go to deal with every conceivable scenario and they would be susceptible to some manipulation. What they do have going for them is that they are (potentially) readily accessible – the question is how to be sure of the information at that point when it is required. It is evident that neither of the two systems of 'IP address' and 'credit card' would individually be capable of providing all the requisite information. However, if they were used collectively and applied by a method of 'tests and check', it would be able to provide a definitive answer. A rule could be made that the jurisdiction given by two tests out of three would be accepted or any other rule of the form "x out of y", if enough tests were available. However, the closer x gets to y, the more often these automatic tests would fail to be decisive. Hence, on the balance, Digital certificate would provide much accurate information, which could also be applied automatically. It would be much easier and reliable to use one decisive method, instead of a combination, and thereby making limited efforts to establish jurisdiction and determine the

tax status of the customer.

#### 10.4.2 TAX RATES AND PRODUCT CLASSIFICATION

The key to getting tax calculated correctly is not to make the calculations simple, but to make the required inputs simple. Once the tax jurisdiction and status of the purchaser is determined, the rate of tax for that jurisdiction must be determined. This rate is often dependent on subtle classifications in the domestic tax code. There is no international consensus as to classification and treatment. Therefore, the proposed system would need to eliminate the multiple definitions of same product or services. It is widely recognized that the current system allows for multiple characterizations of the same product or service when delivered to different jurisdictions, makes the task of compliance for e-commerce businesses extremely cumbersome and unwieldy. This burden would be correspondingly greater for small web-related businesses who do not have the financial or human resources to track changes in these characterizations on international basis. In the proposed system, all the countries and local governments would utilize the same definitions of tangible and digital products and services. Uniform product and service definitions would significantly ease the compliance burden of both traditional and e-commerce businesses. This corrective step would require that States along with their constituent local jurisdictions work together possibly in some organisation such as WTO or OECD to develop the uniform definitions<sup>21</sup>. What is called for is to develop concise, well-formulated definitions, which would be acceptable for all parties. On the other hand, collaboration to develop uniform definitions would motivate certain definitional clarifications, e.g. 'services' vs. 'digitised products,' that would simplify the task of compliance and administration on the parts of both the states and businesses.

Once the jurisdiction and the kind of product is known, the next step would be a universal product coding database 'lookup' which can provide the appropriate tax rate to apply to the value of the sale. Clearly, the ability to harmonise systems and methods as well as the ability to change tax amounts are factors solely within the competence of the governments of the world. It would thus be the primary responsibility of the governments to create such a database for each taxing jurisdiction. This database would be used to determine which products are to be taxed and which are to be exempted. The countries would be able to change the tax rates. This would also reduce the cost of maintenance of the database and the calculating software. The design of the database would be kept simple. Each jurisdiction would use one tax computation formula and one set of parameters, applicable to all sales of digitised products. Different classifications for different digitised products would be eliminated, because otherwise each product would need to be coded as "*category 1 if sold to jurisdiction A, category 4 if sold to jurisdiction B, category 2 if sold to jurisdiction C*" and so on. In such situation people, categorising products would be probable to make mistakes, and changes in categories would be overlooked or misinterpreted. Countries would not be able to unilaterally make changes in the product

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<sup>21</sup> A similar type of product classification system is already in use: United Nations Central Products Classification System (available at [www.un.org/depts/unsd/class/cpcprof.htm](http://www.un.org/depts/unsd/class/cpcprof.htm))

classification, exemption definition, or sourcing rules. Instead, an organisation like OECD or WTO would look after for changes that would be necessary from time to time. Countries would be able make changes to the database as and when such requirement would arise and all the participating countries would have to adopt those changes. This database would also be maintained by the same world organization responsible for co-coordinating such an effort, and would be publicly available free of charge on a website so businesses would always have access to the correct information and that format would allow easy downloading into tax computation programs.

For some commentators development of such a database would be a difficult task, apparently because of the magnitude of the task and number of parties involved, in my view there are precedents of such compilations. The World Customs Organisation publishes a Harmonised Tariff, in which all goods (not services) are capable of being classified for customs purposes under thousands of six-digit categories. The Harmonised Tariff is designed to ensure that a particular good is classified under the same Tariff item regardless of the country of export and import. Each country attaches *its* duty rates to the six digit numbers and the duty rates can and do vary by country. Most of the more than 150 major trading nations use the Harmonised Tariff as the basis for applying customs duties to imports.

#### **10.4.3 TAX COMPLIANCE SOFTWARE**

The next step for the proposal would be to calculate the consumption tax due on each sale. The world organisation (OECD or WTO) which would be responsible for development of product classification would also contract out to develop the software that would lists the State and Local sales tax and VAT rates on all categories of items for all the countries and some of local governments. It would be a technologically neutral system, designed to be incorporated easily into commercial web sites running on any computing platform. Both e-commerce sellers and ISPs would use this software, which would be free 'shareware'. This would reduce network delays before the consumer committing to the purchase, thus enhancing the purchasing experience. When a consumer makes an online purchase, the software would check the tax rate in the area according to the information about the jurisdiction provided in the digital certificate. If the consumer were not using a digital certificate then the software would calculate the tax rate according to the IP address or credit card details, as appropriate. All tax calculations would be performed by the software assuming that it would receive the required data to make the calculation. The software would display the tax rate along with all other incidental charges. When the consumer makes the purchase, he or she would simply pay the full amount (cost of the product, Sales tax or VAT, shipping and handling etc). In addition to a formal acknowledgement of the tax due, it would also provide a reference number that would be used for audit purposes.

Some commentators have suggested that the indirect tax system is too complex to be modelled even with current computer and Internet capacity. This can be easily disproved, as these aspects of this model proposal are already available in existing commercial products, which offer sales/use tax calculations for the approximately 6400 jurisdictions in the US. A company called 'Taxware'

International already employs an online service that tracks all of the sales tax rates of all U.S. state and local tax jurisdictions as well as most VAT jurisdictions and calculates the relevant tax payments (although online vendors must provide customer location information). Combined with IBM WebSphere® Commerce Suite, TAXWARE provides a comprehensive solution for automatically calculating and managing U.S. and international taxes correctly for each transaction from the order information entered into WebSphere Commerce Suite. The new E-Commerce Tax System for IBM represents it is possible to calculate sales, use and consumers' use taxes for both the U.S. and Canada; manage exemption certificates, verify addresses and calculate VAT, Goods and Services tax (GST) and consumption taxes for all of the European Union and most of Asia Pacific and South America<sup>22</sup>.

#### **10.4.4 COST OF COLLECTION**

Who pays for the cost of collection? Tax authorities should also be prepared to pay for the work that would need to be done in the private sector. Normally, tax authorities expect the private sector to bear the cost of compliance with new laws, and they can use the force of the law to make companies comply. However, here, authorities would have to deal with companies, which would be outside their jurisdictions. Hence, it would therefore be reasonable to expect authorities to pay for the work that would require to be done. The objective always remain the same, the cost of compliance should be proportional to the revenue. Currently, the supplier who holds the liability for tax collection enjoys the benefits of this positive cash flow. Under this system, the ISP would share in the benefit received by suppliers depending on their relative contributions to the process, or could remit funds to the government immediately. The cost of development of the software and creation of the Database would share between the different countries calculated in proportion to the Internet usage of the population. Similarly, the deployment and maintenance costs would be apportioned to revenue agencies according to usage. The cost of obtaining digital certificate would also be competitive, as it would create a huge new business potential for this sector. It is currently not clear what type of pricing structure would prevail e.g. fixed initial price + annual charge based on number of users, fixed initial price + percentage annual cost or other pricing arrangement. The cost of integrating the system with the respective vendor websites would be bore by the vendor.

The States or Local governments would pay the ISP on a 'per transaction' basis based on negotiated rates so that burdens of tax compliance would fall on the general revenue system, not vendors alone (*Based on Forester Research's current B2C e-commerce sales forecast by category in US, a 5% commission on the estimated tax collected could generate between \$400 and \$600 million in 2004*). This would act as a source of revenue for the ISPs and hence in the long term it is possible to think of a

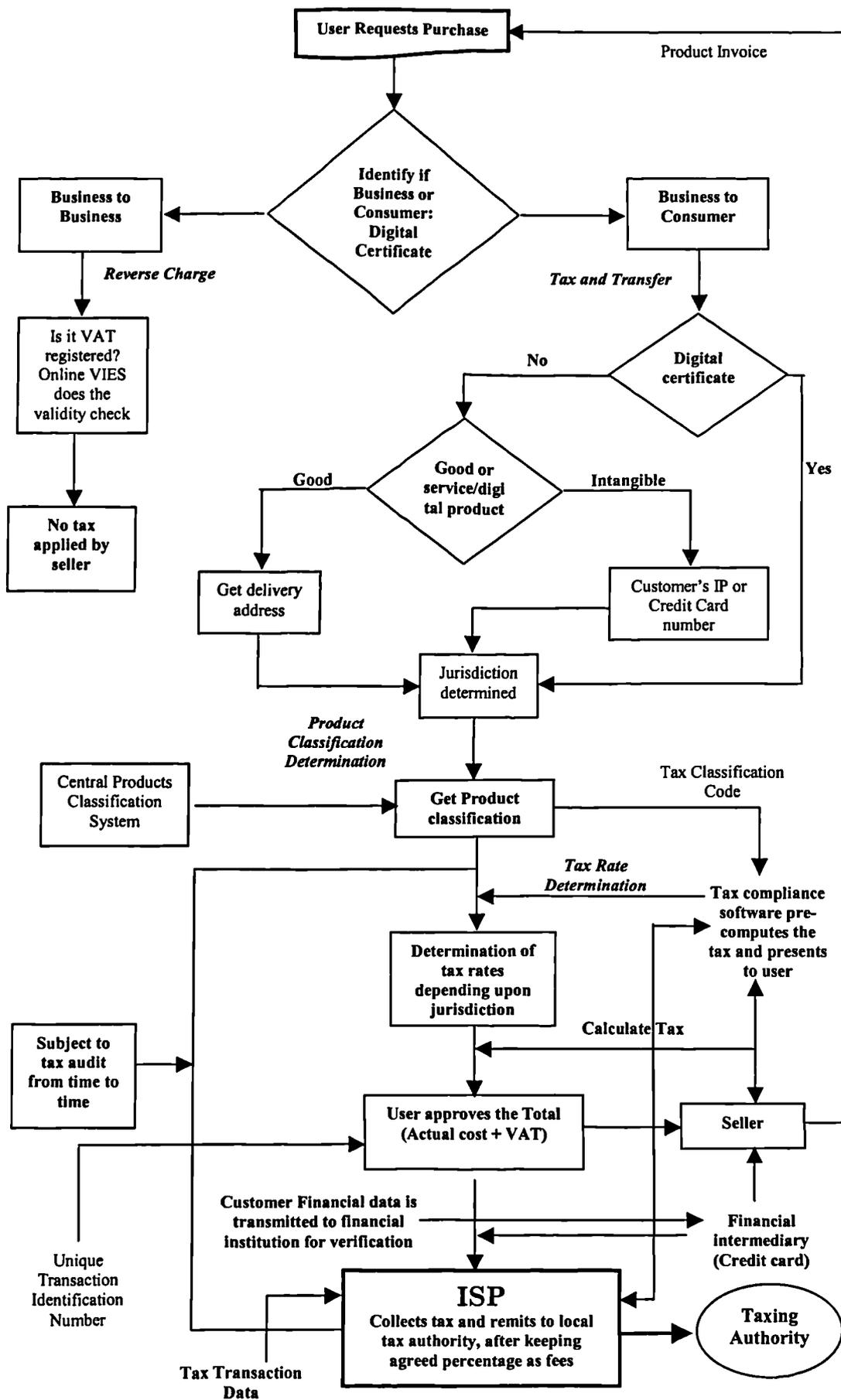
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22 TAXWARE International, Inc. 'TAXWARE's E-Commerce Tax System for IBM', <http://www.taxware.com/>  
See [www.taxware.com/Zproducts/salesuse/sutaxsys.htm](http://www.taxware.com/Zproducts/salesuse/sutaxsys.htm)).

much reduced cost of Internet access, which will be quite beneficial for growth of e-commerce in developing countries. In addition, vendors could also pay a fee for the ISP for the service, which they would be receiving as part of an end-to-end business system. In such a system, the tax module is generally small relative to the other business modules such as order processing, inventory management systems etc., which are being utilised by the vendor.

#### **10.4.5            AUDIT FUNCTION**

The key elements of an auditable system are the detail of the transactions that is available and how easily and in what format that this data may be accessed. The primary audit function would fall on the destination country as the proposal is modelled around the destination principle. Hence, it is the destination country, which will be most interested in compliance. ISPs will act as the principal intermediary in any audit program, thereby alleviating a majority of the burden from businesses. It would be the respective States to decide on the guidelines. The countries should preferably conduct sales audits in the manner that is customary in law within their state. However, the proposal would favour uniform audit procedures, including uniform record-keeping and retention requirements and a uniform statute of limitations and appeals process. Transaction detail would be retained such that an individual seller can be identified but not an individual buyer. The buyer detail would be retained by the seller. A unique number would identify each transaction by the system. Any transaction reports provided to the seller would also contain this number. This improvement would ease the burden on companies by clarifying and simplifying their audit-related responsibilities. As the system would be capable of providing periodic information on taxable sales and tax receipts collected, hence it is suggested that such procedure is undertaken in regular time interval. Since this system is electronic and since it interfaces at the time of the purchase transaction, revenue officials would have an audit trail that is more comprehensive. It is also suggested that the States should allow the filing of tax returns; and the submission of annual reports on the taxable activity by electronic means.



# Chapter - 11

## CONCLUSION

### PROPOSAL AND E-COMMERCE PERSPECTIVES

*'It is not the strongest of the species that survives nor the most intelligent, it is the one that is most adaptable to change.'*<sup>1</sup>

The proposal would be effective and successful from the different perspectives of e-commerce. The proposal is formulated keeping in mind the unique characteristics of the different perspectives. The flexible and dynamic nature of the proposal would make it possible to adapt according to the needs of the different perspectives. If the proposal were looked at from the business perspective, it would provide the necessary elements that are useful for development of e-commerce as business process. It would impose minimum compliance burden on sellers and most part of it would use the existing workflow and the technology, which provides the automation of business transactions. As the proposal would use ISP as the tax collecting authority, hence from communication perspective it would be using the very infrastructure that makes and connects the network. The proposal would also provide collection of consumption tax, as a service and it would form a part of the service perspective of e-commerce

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<sup>1</sup> Charles Darwin

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## CONCLUSION

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providing certainty to tax collection. Although it is the obligation of the consumers to pay the applicable tax, however it is the responsibility of the taxing authorities to provide the simplified tax compliance method. The proposal would provide the simplified procedure for compliance. This proposal would also eliminate the multiple definitions of taxable products and service it would encourage uniform reporting requirements across countries, and thereby simplifying the sales information that must be captured, tracked, and reported to each taxing authorities. Finally, together, these features would place the technology issues entailed by this proposal well within the capabilities of current technology

The proposal is aimed at providing a long-term solution. On the balance of possibility it might seem that the challenge of applying consumption taxes to sales of digitised products to consumers would be too difficult, certainly while the level of such sales remains insignificant. However, there is a counter-argument, to the effect that businesses would want consumption taxes to be applied. The basis of this argument is that businesses within the same jurisdictions as their customers, who do account for tax on those sales, would not wish to be prejudiced by businesses in different jurisdictions that can sell without the burden of tax. Businesses would therefore wish their own tax authorities every success in trying to collect consumption taxes on sales by out-state business. This would level the playing field as between domestic and foreign businesses. It is, however, unusual for businesses to support extensions to the tax base. Certainly, a business would like to see its competitors, selling to customers in its home jurisdiction, lose any cost advantage. On the other hand, a business would wish to have a cost advantage over its competitors selling to customers in other jurisdictions. Therefore, a business might want its own tax authorities to succeed in taxing e-commerce, but it might also want foreign tax authorities to fail. Ultimately taxation is inevitable and any proposal must have the basic elements of fairness and neutrality.

In order to focus on the basic problem, that e-commerce exists in borderless virtual, which de-emphasised the significance of the place in which economic activity is carried out, the proposal is aimed to provide a more borderless feeling by involving the very technology that made Internet and e-commerce possible. However this has led to the question of State Sovereignty; there would be arguments on some of these proposed measures (the proposal for a uniform tax base) would be an unwelcome intrusion on State fiscal sovereignty. This view loses sight of the larger picture. The argument is about the relevance of the above question. The time is right for what might be a turning point in the history of taxation. Until now, national governments have designed and administered their tax polices in near-splendid isolation from one another. Apart from the minimalist and voluntary constrains of the OECD' Model Tax Convention and a network of bilateral treaties to prevent double taxation, States have remained largely autonomous agents of taxation, even as the globalisation of production and commerce and to a lesser extent the globalisation of business regulations have gathered momentum (Braithwaite and Brahos, 2000). The State sovereignty that was possible when local merchants sold primarily tangible products almost exclusively to local customers is no longer possible, or at least not a realistic alternative, as it implies enormous complexity for remote vendors and thus the

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legal inability to tax remote sales, including those in e-commerce. The most likely result of these developments would be a shift in the relative balance of de facto taxing authority from the domestic to the international level, in short, a globalisation of taxation, as States come to realize that technological changes in nature of commerce require considerably higher levels of international coordination in the field of taxation.

Recognizing that states could no longer formulate and enforce tax policy independently, however, did not indicate that the status of the state as an international actor is in decline. Nor did it suggest that sovereignty is no longer a central concern in international relations. States have always faced situations in which they must cooperate with both internal and external actors. The objective of states, in their efforts to arrive at international agreement on taxation also remains the same, to cede enough sovereignty over its domestic taxation policy in order to reap the rewards of international cooperation without losing the means to control their own domestic environment. A cooperative international effort at formulating well-defined, uniform tax laws would provide the benefits of certainty for electronic commerce and an assured minimum level of tax revenue available to the state in satisfying domestic objectives. Although the formal conception of a state sovereignty views the necessary loss of sovereignty over tax policy as a reduction in state power, a functional analysis views the resulting ability to satisfy the domestic welfare objectives considered above as a more realistic indication of state power. The proposal represent an attempt to craft a compromise between the need for revenue and the power to set state tax rates arguably higher orders of state sovereignty and control over the tax base, arguably a less important aspect of sovereignty. E-commerce and the Internet represent the opportunity to leap forward to the next stage of economic development, where value is created not just by resource endowments or manufacturing might, but also by knowledge, information, and the use of technology. Keeping in mind the unconventional nature of e-commerce, any solutions to the taxation of e-commerce need to balance the interests of government treasuries against principles of fair and neutral taxation, efficient compliance, and effective tax administration. To quote from the conclusion of the UK government's position paper on the taxation of e-commerce<sup>2</sup>:

*“ Progress is being made to give business the certainty it needs about the way in which international transaction will be taxed. The Government is working with international partners on the issues which e-commerce raises in this area to ensure that clarification is provided in a number of area... At the same time, the Government is aware of business concerns that it should not too hastily to change long standing and widely accepted concepts, since changes brought in too rapidly might work inappropriately as technology develops. The Government agrees with this analysis and will continue to monitor closely how developments in technology will affect internal tax rules ... ..so as to be ready to adopt ... ”*

This cautiously optimistic statement reflects the acknowledgment by the major economies of the realities of new technology: that the balance between developing and developed economies can change as a result of growth of e-commerce and that no satisfactory solutions to the related problems can succeed without a very broad international consensus and substantial utilization of the technology.

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<sup>2</sup> Inland Revenue publication Electronic Commerce: The UK's Taxation Agenda (1999)

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