

T.C.
MARMARA UNIVERSITY
EUROPEAN COMMUNITY INSTITUTE
DEPARTMENT OF EUROPEAN UNION LAW

**TAXATION OF ELECTRONIC COMMERCE
AND EUROPEAN UNION LAW
(M.A.)**



H.Galip KÜÇÜKÖZYİĞİT

Istanbul,2002

**T.C. YÖRSEKURBETİM KURULU
DOKÜMANTASYON MERKEZİ**

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Supervisor: Assoc.Prof. Dr.T.Murat YÖRÜNG

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Subject of the thesis; *'Taxation of Electronic Commerce and European Union Law'* is also perceived because of my curiosity about emerging legal areas. Electronic Commerce is an emerging way of conducting business, it is predicted to have effect on our lives, and yet not widely examined, discussed, defined by law. This is the reason why I preferred such a subject. It is certain that I don't pretend that I made a contribution to the subject, but I may say I put forward my way of study and process of learning for those who are interested in the field. I might also add that what I learned is much more than what I am able to offer.

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H.Galip KÜÇÜKÖZYİĞİT

ABBREVIATIONS

IS	Information Society
MIT	Massachusetts Institute of Technology (MIT)
ARPA	Advanced Research Projects Agency
ARPANET	Advanced Research Projects Agency Net
www	World Wide Web
FNC	The Federal Networking Council
IP	Internet Protocol
TCP/IP	Transmission Control Protocol/Internet Protocol
CEO	Chief of Executive Order
EU	European Union
ITFA	Internet Tax Freedom Act
CTA	Canada's Tax Administration
UK	United Kingdom
OECD	Organisation of Economic Co-Operation and Development
PC	Personnel Computer
EDI	Electronic Data Interchange
ATO	Australian Tax Office
ICT	Information and Communication Technologies
B2B	Business to Business
SMEs	Small and Medium Enterprises
UNCITRAL	The United Nations Conference on International Trade Law
WIPO	World Intellectual Property Organization
WTO	World Trade Organization
IPRs	Intellectual Property Rights
CD	Compact Disc
URL	United Resource Locator
ITC	International Trade Council
FEI	Federation of Electronic Industry
ICRT	The International Communications Round Table
HLEG	High Level Expert Group
CFA	The Committee on Fiscal Affairs

ASP	Application Service Provider
MNE's	Multi-National Enterprises
GIIC	Forum for the Global Information Infrastructure
TAG	Technical Advisory Groups
G7	Group of Seven Nations
APEC	Asia-Pacific Economic Cooperation
UNCTAD	The United Nations Conference on Trade and Development
UNISTE	UN International Symposium on Trade Efficiency
ITU	Telecommunication Union
ITC	International Trade Centre
ITA	Information Technology Agreement
MRAs	Mutual Recognition Agreements
PE	Permanent Establishment
DTAs	Double Taxation Agreements
ECJ	The European Court of Justice
GST	Goods-and-Services tax
SUT	Sales and Use Tax
E-mail	Electronic Mail
ECSC	European Coal and Steel Community
EC	European Community
TEU	The Treaty on European Union
DG	Directorates General
GDP	Gross Domestic Product
JILT	Journal of International Law and Technologies
MJES	Marmara Journal of European Studies
Art.	Article
Par.	Paragraph

PART 1: TELECOMMUNICATIONS REVOLUTION AND E-COMMERCE

CHAPTER 1.. THE INFORMATION AGE AND ECONOMY

Our generation stands on the very cusp of the greatest technological revolution that mankind has ever faced. Some compare this age of electronic communication with the arrival of the Gutenberg press, or with the industrial revolution. Yet this revolution when it has run its course may have a greater impact on the planet than anything that has preceded. The applications of electronic transmissions are just beginning to be felt... and the breadth and depth of what lies ahead is only beginning to be fathomed. How and where we are educated, where and how we work and live, our health care systems, our shops, our commerce, our reading, our leisure... no part of human enterprise will be spared unchanged. Even our notions of sovereignty and governance could be profoundly affected.¹ There is widespread agreement that convergence is occurring at the technological level. That is to say that digital technology now allows both traditional and new communication services - whether voice, data, sound or pictures - to be provided over many different networks.²

We have entered the 'information age' in so far as *information is a defining feature of contemporary society*. The networking of the world through fibre optics, satellites and wireless communications has created a global community.³ How do we define *the Information Society* then? The Information Society is the society that is currently being put into place which involves a general utilisation of techniques of information and data storage and transmission at low costs. Such generalisation of information and data use is being accompanied by organisational, commercial, social and legal innovations that will profoundly change life at work and in society.⁴

¹ Sacher Report, Group of High Level Private Sector Experts on E-Commerce p.3, oecd.org/dsti/it/ec/act/SACHER.HTM

² EU Commission, *Green Paper on the Convergence of the Telecommunications Media and Information Technology Sectors and The Implications for Regulation*, Brussels, 3 December 1997

³ GAIL Evans and FITZGERALD Brain, 'Information Transactions' University of NSW Law Journal, auslieduu/journals/UNSVLJ/46htm#fn200

⁴ Sacher Report, p.4

Globalisation is making truly global commerce a practical reality.⁵ Potentially, global networks could make it as easy to do business with a company on the other side of the world as with one on the next street.⁶ The global nature of communication platforms today, in particular, the Internet, are providing a key which will open the door to the further integration of the world economy. The businesses those disseminate themselves on the web has potential to a global reach even they are very small.⁷ Globalisation will therefore be key theme in future developments⁸ that will play a core role in shaping our future lives.

According to Nicholas Negroponte, the author of *Being Digital*, we are, at least partially, *in the transition from an economy based on the movement of "atoms" to one based on "bits."* The digital age is founded on the instantaneous and inexpensive transfer of electronic data. According to Negroponte, "The information superhighway is about the global movement of weightless bits at the speed of light."⁹

The maturation of global communications network provided capstone to the emerging pre-eminence of the information based economy. An agricultural based economy dominated world commerce up until the 19th century, whereas an industrial based economy dominated world commerce in the 19th and 20th centuries. Beginning in the 20th century, the information based economy – so called the new economy - has begun to supplant both agricultural and industrial activities at the centre of global commerce.¹⁰ First, the shift from a manufacturing based economy to a service based economy has been reinforced by the explosive growth of the information technology industry. Second, the sharply falling costs of transportation and communications -so called death of distance - have accentuated the development of an integrated global marketplace in which intermediate inputs and final products move more freely among states and nations. Finally, *the growth of direct marketing and distance selling through means of information age like facsimile, telephone, mail order, telemarketing, television shopping networks, and most recently, internet retailing has vastly expanded the proportion of "remote commerce" that can be conducted almost instantaneously*

⁵ European Commission, Information Society Directorate-General, Electronic Commerce: An Introduction, cec.eu.int/ecommerce

⁶ *ibid*

⁷ DAUPHINAIS, W., CEO'ların Bilgeliği, Sistem Yayıncılık, Ocak 2002, İstanbul, p.218

⁸ European Commission, Green Paper

⁹ NEGROPRONTE Nicholas, *Being Digital*, Vintage Books, New York, 1995 ,p19

¹⁰ FRIEDEN Karl, *Cybertaxation*, CCH Incorporated, Chicago, 2000, p.19

between vendors based in one location and consumers in another.¹¹ In terms of economy, the communication tools, particularly the Internet are changing continuously the nature of the global marketplace.¹²

CHAPTER 2.. THE INTERNET AND ITS BRIEF HISTORY

The Internet –the crowning achievement of the late 20th century or as widely called information age- has leaped into the world’s consciousness during the second half of the 1990s. Prior to 1994, there was a little public awareness of the Internet or its potential for revolutionising our lives.¹³

The Internet is a worldwide network of computers and connections that uses a common communications language. This communications language provides a common link that enables individual computer systems to interact with one another.¹⁴

The idea of Internet first has been brought into life by J.C.R Licklider at Massachusetts Institute of Technology (MIT) in 1962, by the concept of “Galactic Networks”. Licklider imagined some pairs of connected computers through which data and programmes would be accessed rapidly by the users at the same time.¹⁵ This imagination has been followed by establishment of a Computer Research Programme within ARPA (Advanced Research Projects Agency) and Licklider has been appointed as director. In 1965, Lawrence G. Roberts und Thomas Merill achieved a very slow distant communication via two connected computers. This very small size net can be accepted as the first computer net of the world. By the end of 1969 there were four host-computers all connected to each other within the ARPANET; by this, the rise of the Internet begun. In the following years, many other computers would be connected to ARPANET.¹⁶

In the following years, the Internet has been developed as part of a Department of Defence project aimed at developing a computer-related communications system linking government agencies, university research facilities and high-tech defence contractors. The objective was to develop communication protocols which would allow

¹¹ FRIEDEN Karl, p.1

¹² FRIEDEN Karl, p.2

¹³ FRIEDEN Karl, p.3

¹⁴ HILL Elizabeth, *California Tax Policy And The Internet*, A Report Of Legislative Analyst’s Office, p.4, int.tax.caltax.org/ecommerce.htm

¹⁵ Internetgeschichte

¹⁶ Internetgeschichte

networked computers to communicate transparently across multiple, linked packet networks.¹⁷ As the original system evolved, it expanded beyond the original participating institutions, and included broader industry and government participation, as well as encompassing commercial, non-profit, and individual users. In the 1990s, much of the Internet system was turned over to private industry.¹⁸ The Internet and its graphical subnetwork called the World Wide Web (developed in 1989) enable millions of computers (or other communication apparatus) using different hardware, operating systems and software application programs to link to each other by a common protocol.¹⁹

The Internet is an international, open-ended aggregation of computer and communications networks, people who use those networks, and resources that can be accessed from those networks.²⁰ To define the term, The Federal Networking Council (FNC) unanimously passed a resolution on October 24, 1995, where the term has been defined as : "Internet" refers to the global information system that -- (i) is logically linked together by a globally unique address space based on the Internet Protocol (IP) or its subsequent extensions/follow-ons; (ii) is able to support communications using the Transmission Control Protocol/Internet Protocol (TCP/IP) suite or its subsequent extensions/follow-ons, and/or other IP-compatible protocols; and (iii) provides, uses or makes accessible, either publicly or privately, high level services layered on the communications and related infrastructure described herein".²¹

*The Internet has revolutionised the computer and communications world like nothing before. It is at once a world-wide broadcasting capability, a mechanism for information dissemination, and a medium for collaboration and interaction between individuals and their computers without regard for geographic location.*²² The Internet is as much a collection of communities as a collection of technologies, and its success is largely attributable to both satisfying basic community needs as well as utilising the community in an effective way to push the infrastructure forward.²³

¹⁷ CERF G., *A Brief History of the Internet and Related Networks*
isoc.org/internet/history/cerf.shtml

¹⁸ HILL Elizabeth, *California Tax Policy And The Internet*,p.6

¹⁹ PERLER Gary, *Taxation of Cyberspace: State Tax Issues Related to the Internet and Electronic Commerce*, caltax.org/Andersen/ecommerce.htm

²⁰ CAYO Carol , *Straight Talk Internet Tax and Interstate Commerce*, itaa.org/govt/pubs/stalk.htm

²¹ Federal Networking Council ,*Resolution On Internet*, fnc.gov/Internet_res.html

²² CERF G.,*A Brief History of the Internet* isoc.org/internet/history/brief.shtml

²³ *ibid*

The growth in the commercial sector brought with it increased concern regarding the standards process itself. Starting in the early 1980's and continuing to this day, the Internet grew beyond its primarily research roots to include both a broad user community and increased commercial activity.²⁴ Mostly due to its advantage of global network of computers with high-speed data lines and wireless systems, much of market research -both supplier and consumer- activities have been moved into this new cyber world.

The Internet has now become almost a "commodity" service, and much of the latest attention has been on the use of this global information infrastructure for support of other commercial services. This has been tremendously accelerated by the widespread and rapid adoption of browsers and the World Wide Web technology, allowing users easy access to information linked throughout the globe.²⁵ Almost %80 of the CEOs throughout the world believe that electronic commerce has the potential to re-shape the market structure and competition in their sector.²⁶

*The Internet has changed much in the last two decades since it came into existence, it started as the creation of a small band of dedicated researchers, and has grown to be a commercial success with billions of dollars of annual investment.*²⁷

To stress the impact of internet, the following formulations will definitely give a concrete idea: The intensity of internet use reflects levels of economic development; the internet is a powerful tool for trade, it is an emerging global trading platform, its real impact is still to be seen, and growth areas are emerging.²⁸

CHAPTER 3.. ELECTRONIC COMMERCE

3a. Definition:

New information and communications technologies such as the Internet are creating exciting opportunities for workers, consumers, and businesses. Information, services, and money may now be instantaneously transferred anywhere in the world. Firms are increasing their imports and exports of goods, services, and information as the costs associated with participating in global markets plummet, and they are forming

²⁴ *ibid*

²⁵ *ibid*

²⁶ DAUPHINAIS, W., *CEO'larnn Bilgeliđi*, Sistem Yayıncılık, Ocak 2002, İstanbul, p.218

²⁷ CERF G., *A Brief History of the Internet*

²⁸ BELISLE Denis, *Secrets of E-commerce*, ITC Publications, Geneva, 2001, p.7

closer relationships with suppliers and customers around the world.²⁹ *Five years ago, the terms "electronic commerce" and "e-commerce" were virtually unheard of; today, they are household words.*³⁰ It has become a term that is used extensively by businesses, media, and individuals.³¹ *Notwithstanding the common usage of these terms today, the meaning and breadth of these terms are still very much uncertain.* For example, it could be argued that e-commerce refers only to transactions conducted over the Internet; conversely, e-commerce could include all transactions using the same telecommunications infrastructure as the Internet such as catalogue orders placed by telephone or facsimile.³² Despite the efforts of governments, business sector, academic environments to bring a concrete definition to the term, *there has been no world-wide accepted definition of electronic commerce yet.* The definitions given by different people throughout the literature differ dramatically, many of them being vague and inaccurate.³³

Electronic Commerce refers generally to all forms of commercial transactions involving both organisations and individuals that are based upon the electronic processing and transmission of data including text, sound and visual images. It also refers to the effects that the electronic exchange of commercial information which includes organisational management, commercial negotiations and contracts, legal and regulatory frameworks, financial settlement arrangements, and taxation, among many others.³⁴ Electronic commerce is most shortly and generally defined as transactions that involve the exchange of goods and services by electronic means.³⁵

To clarify the ambiguity, it could be a good idea to make a comprehensive examination of the definitions and statements made by various academic, governmental and business institutions. This will help develop a good understanding of what is meant by the term Electronic Commerce.

The EU ESPIRIT Program defines e-commerce as: "*any form of business transaction in which the parties interact electronically rather than by physical exchanges or direct physical contact*",³⁶ where an early definition given by the US Government sounds a similar wording as: "*Electronic commerce is the ability to perform transactions*

²⁹ California Tax Office, *Selected Tax Policy Implications of E-commerce* .caltax.org/treas-ec.html, p.2.

³⁰ GILMORE James (Chairman), Advisory Commission On Electronic Commerce (ACEC), *Report To Congress*, April 2000 , p.7 ecommercecommission/report.pdf.

³¹ INES Langeder, *Income Tax Implications Of Electronic Commerce*, p.21 univie.ac.at/steuerrecht/e-commerce-Langeder_Ines.pdf

³² ACEC Report p.7

³³ INES Langeder , p. 7

³⁴ Sacher Report, p.24

³⁵ California Tax Office, *The Taxation of Cyberspace*, caltax.org/Andersen/contents.htm

involving the exchange of goods or services between two or more parties using electronic tools and techniques."³⁷ As to the Australian agencies, electronic commerce is "every type of business transaction in which the participants prepare or transact business or conduct their trade in goods or services electronically" and thus, businesses are being encouraged to adopt electronic commerce.³⁸

"E-commerce," as defined in the US Internet Tax Freedom Act, includes "any transaction conducted over the Internet or through Internet access, comprising the sale, lease, license, offer, or delivery of property, goods, services, or information, whether or not for consideration, and includes the provision of Internet access."³⁹

In one of its reports on the subject, The European Commission prefers mentioning electronic commerce as: "The ability to undertake commercial transactions over the electronic networks, which involve the exchange of value between the parties involved,"⁴⁰ meanwhile Canada's Tax Administration deserves mentioning it as; the delivery of information, products, services or payments by telephone, computer or other automated media'.⁴¹

Whilst there is no internationally accepted definition of e-commerce, the UK 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 private sectors, whether paid or unpaid".⁴²

The UK Taxation office prefers a more simple definition: 'E-commerce is most simply described as *doing business electronically*, whether communicating by PC, interactive television, console gaming machine or through high street kiosks.' It includes Electronic Data Interchange (EDI), the exchange of documents in structured or coded form between business computers, which began over a decade ago.⁴³

³⁶ European Commission, E-Commerce: An Introduction, p.3

³⁷ California Tax Office, *Selected Tax Policy Implications of E-Commerce*, caltax.org/treas-ec.html=1-2

³⁸ IFAC Articles, "Department of Communications, Information Technology and the Arts, *Australia's e-commerce Report Card*", Canberra, 1999.

³⁹ ACEC Report p.8

⁴⁰ EU Commission, *Interim Report on the Implications of Electronic Commerce for VAT and Customs*, p.5

⁴¹ INES Langeder, p.20, also see rc.gc.ca/ecom

⁴² Financial Secretary to the Treasury, *UK's Taxation Agenda* p.30

inlandrevenue.gov.uk/taxagenda/ecom.pdf

⁴³ UK's *Taxagenda* p.13

The ATO(Australian Tax Office) defines E-commerce as ' the buying and selling of the goods and services on the internet' ⁴⁴. A similar but more extensive definition has been developed by Doernberg as: "The use of computer networks to facilitate transactions involving the production, distribution, sale, and delivery of goods and services in the marketplace." According to this, applications of e-commerce include the paperless exchange of business information from business computer to business computer using electronic data interchange (EDI) technology, electronic mail, electronic bulletin boards and conferencing software, electronic funds transfers, and many other technologies.⁴⁵ These two internet and computer based definitions are for sure taken too narrow.

As a result we have to distinguish between two terms that are often been used interchangeably; E-Commerce and Internet Commerce. They are often used in the same way, but they shall be differentiated for clarification: *E-commerce* describes more general transactions, including those using technical means also other than the internet. *Internet Commerce* on the other hand only stands for those parts of electronic Commerce that are conducted via the Internet. Therefore *Internet Commerce is only a part of Electronic Commerce*.⁴⁶ A commercial transaction can be divided into three main stages: the advertising and searching stage, the ordering and payment stage, and the delivery stage. Any or all of these stages can be carried out on the net and may therefore be covered by the concept of e-commerce. ⁴⁷ Electronic Commerce can be supported technologically in a number of ways, but it is the considered view of the European Union's High-Level Group of Experts that *the Internet is potentially the most significant vehicle for Electronic Commerce to have yet emerged*.⁴⁸

In order to explore and estimate socio-economic impacts of e-commerce, it is essential to define electronic commerce. As with many new services, this is not a simple matter, as definitions given by various sources differ significantly. Future work analysing e-commerce would clearly benefit from the adoption of a definition that would provide some consistency across studies and the reference point for the collection of data. Work to develop a definition should be undertaken at the national and international level in consultation with business, labour, and consumer representatives as well as with

⁴⁴ ATO, *Tax and the Internet*, Canberra 97, p.3, ato.gov.au/ccp

⁴⁵ INES Langeder p.7

⁴⁶ INES Langeder p.21

⁴⁷ International Trade Center(ITC), *Secrets of E-Commerce*, ITC Publications, Geneva,2001,p.4

⁴⁸ Sacher Report, p.24

academic and governmental institutions. Because of inherent differences in policy interests, a flexible definition based on a core concept which then be expanded to include other aspects of e-commerce may be the most practical.⁴⁹

3b. Types of E-Commerce

There is no question that regardless of its exact magnitude, Internet and e-commerce activity is extensive and rapidly growing, with similar trends expected for the future as this new technology continues to evolve and expand in scope.⁵⁰ Among various categorisations, the following grouping comes up as the most cognitive and comprehensive.

3.b.1.. According to Mode of Delivery: Direct and Indirect E-Commerce

E-commerce is part of an evolving approach to business that can involve the application of Information and Communication Technologies (ICT) to the production and distribution of goods and services on a global scale. E-commerce is generally defined as transactions that involve the exchange of goods and services by electronic means.⁵¹ It can be used to support fully automated transactions that involve human and physical interfaces and intermediaries of various kinds. So according to these differences in the mode of delivery, we can differentiate it as: a) some goods and services (computer software, electronic books, games, movies and other forms of entertainment and financial and professional advice) are downloaded onto the computer of their purchaser. The Internet is not only an efficient order management medium, but also a means of delivering a product itself. Customers can conveniently download any form of software such as digitised music or games, or other intellectual property such as training material or consultants' advice.⁵² b) Physical or tangible goods and services which are distributed by using conventional delivery channels (retail store, postal mail). The distinction between these is the former stands for direct e-commerce where the latter rather implies indirect Electronic Commerce⁵³.

⁴⁹ WYCKOFF A. and COLLECHIA A., *The Economic and Social Impact of E-Commerce*, OECD Publications, Paris 1999, p.29

⁵⁰ California Tax Office, California Tax Issues on Internet p.8 int.tax.Caltax.org/ecommerce.htm

⁵¹ FRIEDEN Karl, *Cybertaxation*, p.8

⁵² SCHULZE Corinna, *Don't Panic Do E-Commerce* Published by the European Commission's Electronic Commerce Team (Information Society Directorate General), p.62

⁵³ INES Langeder p.9

The two terms are described by EC Commission as follows: *Direct Electronic Commerce is the online ordering, payment and delivery of intangible goods and services. Indirect Electronic Commerce is the electronic ordering of tangible goods, which must be physically delivered using traditional channels such as postal services or commercial couriers.*⁵⁴

Although e-commerce previously expanded in other channels such as postal mail, facsimile, telephone order, corporate intranets and home shopping networks that can be called indirect e-commerce, today, there is a vast tendency to the direct e-commerce occurring via internet; the most explosive and visible symbol of the multimedia linkage of data audio-video transmissions all in a single commercial pathway.⁵⁵

3.b.2.. According to Parties of Transactions

Electronic commerce can further be sub-divided into five distinct categories according to properties of the parties of the transaction:

- **Business to Business (B2B)** Electronic commerce can be defined as carrying out of commercial activities between two or more businesses by electronic tools. An example in the *business to business* category would be a company that uses a network for ordering from its suppliers, receiving invoices and making payments. This category of electronic commerce has been well established for several years, particularly using Electronic Data Interchange (EDI) over private or value-added networks. Currently, business to business e-commerce activity dominates overall electronic commerce. It is estimated that the segment accounts for at least 80 per cent of e-commerce activity.⁵⁶
- **Business to Consumer (B2C, C2B):** It is carrying out any kind of commercial activity between business and individual consumers. *This category largely equates to electronic retailing.* This category has expanded greatly with the advent of the World Wide Web. There are now shopping malls all over the Internet offering all manner of consumer goods, from cakes and wine to computers and motor cars. The business to consumer segment is seen as

⁵⁴ EU Commission, Green Paper 1997(157)

⁵⁵ FRIEDEN K., *Cybertaxation*, p.8

⁵⁶ OECD, *The Economic and Social Impact of E-Commerce*, p.12

potentially very important for the future due to developing direct online delivery opportunities.⁵⁷

- **Consumer-Consumer (C2C):** It is occurrence of selling and buying of goods and services by individuals to each other often in auctions or by other means via the internet.⁵⁸
- **Business-Administration (B2A):** The *business-administration* category covers all transactions between companies and government organisations. For example, in the USA the details of forthcoming government procurements are publicised over the Internet and companies can respond electronically. Currently this category is in its infancy, but it could expand quite rapidly as governments use their own operations to promote awareness and growth of electronic commerce. 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.
- **Consumer-Administration (C2A-A2C):** 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.⁵⁹

3.b.3. According to Systems Used

Closed System E-Commerce

Closed system E-commerce is often characterised by:

- closed user groups - participants are identified and authorised in advance (eg. Coles Myer and suppliers);
- Master Trading Agreements between parties concluded in advance containing:
 - protocols for communication, authentication, security;
 - terms and conditions of trade; and
 - Payments Agreement between parties and financial institutions in which there is an allocation of risks of unauthorised or altered messages.

⁵⁷ *ibid*

⁵⁸ ITC, *Secrets of E-Commerce*, p.5

⁵⁹ EU Commission, *Electronic Commerce: An Introduction*, p.3

Examples include particular transaction types or industry categories (eg. air travel, CHESS) and closed often proprietary, communication networks (eg. ATM, EFT, POS), although it may occur over open networks such as the Internet.

Even in closed systems there may be a need to authenticate the identity and attributes of remote parties communicating through the closed system (eg. a bank needs to authenticate the identity of a person purporting to be its customer).

Open System E-Commerce: Building Trust

Open system E-commerce using open networks (eg. Internet) can occur between strangers without prior identification or authorisation of the parties or prior agreement of contract terms.

On each interaction on the network:

- the identity and authority level of parties may need to be authenticated (eg. the identity and financial authority of a corporation's purchasing officer); and
- terms of trade must be agreed.

Preferably these should be done on-line, in real time, in that user session particularly because the delivery of digital products and digital payment also can occur on-line.⁶⁰

3c. Impacts of e-Commerce

As well known in the not too distant past -- before 1900 -- most people worked in agriculture. When automation of one sort or another took place, people moved off the land to the new jobs opening up in manufacturing. Over the next decades automation of one sort or another took place and people moved to the new jobs opening up in the service sector. Now that the service sector is itself being automated, it is not clear where workers go. Where do people find work in an increasingly automated world?⁶¹

No doubt that information technology revolution is like no other. It is energy saving, capital saving and labour saving. It is also distance insensitive. It can replace people in a great number of functions. Remembering, deciding, judging, estimating, counting, etc., can all be done by information technologies, and can be done better, faster and cheaper than by people. So we are going into a time of innovation and

⁶⁰ KLIMT Steven, *A Guide to Electronic Commerce*, Clayton Utz Seminar Papers, claytonutz.com.au/p_ecomm/ec_980709.htm

⁶¹ Arthur Cordell, *New Taxes For a New Economy*, Government Information in Canada, V:2, No:4/2

greatly increased productivity throughout the economy.⁶² What will be the advantages and disadvantages of this new economy for our society? Such questions show us that there are socio-economic impacts of digitalisation and commercialisation of electronic tools. In order to better respond the above questions, and to determine new policies about e-commerce, it is necessary to examine and understand the economic and social implications of e-commerce.⁶³

The development of the Internet is top actual and difficult problem which must be very deeply discussed and analysed.⁶⁴ There is no question that e-commerce has changed the business world and established new forms of business environment. Along with the use of internet for conventional forms of commerce, it supplies new revenue opportunities in frame of quality and delivery which are not possible with conventional means.⁶⁵ The possible impacts have often been pointed out by many authors, governmental and business statements.

The EU-US Joint Statement on Electronic Commerce at the beginning mentions the impacts of it; *“Global electronic commerce, driven by the development of the Internet, will be an important engine for growth in the world economy in the 21st century. Electronic commerce offers considerable new opportunities for business and citizens in all regions of the world. In particular, small companies will be able to obtain unprecedented access to world-wide markets at low costs and consumers will be able to choose from an even wider range of products and services. Electronic commerce will enhance productivity across all sectors of our economies, further encourage both trade in goods and services and investment, create new sectors of activities, new forms of marketing and selling, new revenue streams and, most importantly, new jobs.”*⁶⁶

In its Communication the EU Commission stressed these impacts generally as *“The Internet is rapidly evolving from primarily a communication tool to becoming a global trading platform. The rapid growth of the Internet and its development as a tool to facilitate commercial transactions is opening up considerable new opportunities for business and consumers in Europe. The Framework Communication “A European Initiative in Electronic Commerce” noted that “by its very nature, electronic commerce is transnational and encourages cross border ordering and delivery of goods and services*

⁶² Arthur Cordell, *New Taxes For a new Economy*

⁶³ OECD, *The Economic and Social Impact of E-Commerce*, p:11

⁶⁴ Axell Conrad, *Bestuerung des Internets*, p.1, axell-conrad.de/tax

⁶⁵ TAGEN Karen, *Internet und Steuern - ein heikles Thema: Vernetzung*

⁶⁶ *Joint E.U. -U.S. Statement on Electronic Commerce (5 December 1997)*, qlinks.net/comdocs/eu-us.htm

in the Single Market, that it directly stimulated European growth and competitiveness, and that it represents "a potentially vital factor for cohesion and integration in Europe".⁶⁷

At the same time, however, electronic commerce is presenting new challenges. The new global markets that are emerging will no longer be constrained geographically. It will become potentially more difficult to know the location and identity of the parties to transactions. This will present authorities with challenges needing careful study in partnership with the business community.⁶⁸

E-commerce is already having a major impact on the life and economy of the nation and will have an increasing role in the next Millennium. Its main tool is the Internet and, whether actively participating in it or not, few people will be unaffected by a means of global communication that is so powerful in operation, yet so simple to use. The Internet offers consumer choice, business efficiency and recreation. Other developments in trade and communications have probably been as revolutionary but none has grown and changed at such a phenomenal pace.⁶⁹ E-commerce is a "win-win game" and presents enormous potential opportunities for consumers and for businesses, particularly SMEs, and will have a considerable impact on competitiveness in global markets.⁷⁰

When we examine carefully we see it is not an exaggeration to conclude that electronic commerce has very deep impacts on every part of human life, business life, administrative procedures etc. It is here important to make a very brief summary.

3c.1. Economic Impact

a) *Employment effects:* The electronic commerce should lead to greater investment and hence employment in the content business to satisfy the increasing demand. This will be felt both in large companies seeking to reorient themselves towards the new markets, and in SMEs seeking to exploit niche markets. SMEs will combine their use of standardised digital platforms. *Staff retraining* will be an important requirement, Gearing up for the new markets will need people with the right mix of skills, for which specialised training will be required.

⁶⁷ EU Commission, Communication on *E-Commerce and Indirect Taxation*

⁶⁸ *ibid*

⁶⁹ *UK's Taxagenda*, p.2

b) *Creation of New Jobs:* E-commerce is on the verge of revolutionising both business to business and business to consumer sales by introducing a number of new business models for connecting suppliers and consumers.⁷¹ These models include network security specialists, core programmers, internet architects and e-commerce business analysts.⁷²

c) *Research and Development:* It is a well-known acceptance that it will be far beyond easier to make market researches and develop the business in the light of research results by the contribution of e-commerce. The advantage of new technology has already started skipping loss of time for bureaucratic necessities especially while applying to foreign business institutions and commerce departments of consular bodies for market research and business development opportunities. The correspondence takes place directly, more rapidly –even instantly- by e-mails, and relatively less formal.

d) *New services:* The flexibility of digital information is creating the possibility for more and enriched conventional services, (such as digital television and radio and better quality mobile communications), as well as a whole range of new services and applications. These new services are as varied as electronic newspapers, on-line supermarkets and catalogues, home-banking, and the use of multimedia web sites for both internal communications, and as a key tool for business.

e) *New players:* It also marks the entry of powerful new players from publishing and IT industries. For information providers, such as publishers, database operators and financial information services, the Internet constitutes a crucial extension of their traditional know-how, and an ideal means of recycling and "repurposing" rich stores of information.

f) *New market structures:* Some argue that new market structures reflect a substantial shift in the value chain, with value migrating from simple delivery to the production and packaging of content or the offer of on-line of services and transactions. Liberalisation and competition, coupled with digitisation and significant increases in network capacity of both broadcasting and telecommunications networks, is rendering the transmission and delivery of services a commodity item, converting it into a low-margin high-volume business. Firms currently operating in the lower parts of the value

⁷⁰ Report on the communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions on a European Initiative in Electronic Commerce (COM(97)0157 - C4-0297/97), 4 May 1998 A4-0173/98,

⁷¹ FRIEDEN K., *Cybertaxation*, p.36

⁷² Further reading, OECD *The Economic and Social Impact of E-Commerce*, p.21

chain are therefore seeking to increase volume on their core activity, through horizontal alliances or organic growth into new geographical markets.

At the same time, they are moving up the value chain to higher margin activities through vertical concentration. It also indicates the types of commercial relationship which are emerging between different actors. The situation is reinforced by the emergence of new industries filling in the gaps between adjacent sectors; some of the start-up companies pioneering on-line computer networking services a decade ago have grown into multi-billion dollar groups today.

g) The consumer perspective (The changing patterns of consumption): Consumers are likely to use new products and services offered through convergence only insofar as those services are useful to them. The take-off of new services cannot therefore be simply supply-driven, but must take account of demand and, in particular the consumer viewpoint.⁷³

3c.2. Social Impact

Electronic commerce is predicted to have an equivalent impact on society and employment as the industrial revolution did a century before. The new services and activities made possible through the range of technological and market trends identified above have the potential to impact every aspect of our lives, from our homes to our work place; from the way we do business to the way we learn; from access to healthcare to the management and delivery of public services and to the way citizens participate in a democratic society.

Electronic commerce forms part of a broader process of social change, characterised by the globalisation of markets, the shift towards an economy based on knowledge and information and the growing prominence of all forms of technology in everyday life. These major societal transformations are now under way and will probably continue in to the foreseeable future.⁷⁴ The following examples are the most significant titles that social impact is to be felt.

a) Training and Education: Computer and information technologies have begun to make a significant contribution to strengthening the social infrastructure through improvements in education and other aspects of human resource development, including the sense of community. The demand for education and training concerns the

⁷³ EU Commission, Green Paper p.11

⁷⁴ OECD, *The Economic and Social Impact of E-Commerce*, p.143

full range of modern technology, including robotics, biotechnology and communications which involve virtually all economic sectors. Information technologies are uniquely capable of providing ways to meet this demand. For instance, the internet is at the centre of a learning revolution by online training and self study courses at a supplier's website to complete electronic classrooms.

The initial audience for more computerised distance learning is likely to derived from non residential college students, continuing adult education courses designed for working people and job training programs. Indeed, a growing number of schools are being established that provide education entirely by remote electronic means. For instance, Jones International University near Denver, Colorado, is the first "virtual" university in the US, operating entirely online with full accreditation.⁷⁵

b) A Sense of Community: E-commerce and ICTs abolish distance and alter the concept of community. Many of these changes are positive creating links with new people, maintaining closer ties with far-flung friends and family members, and *creating new online communities with potentially global membership.*

c) Time Effects: The changes that e-commerce brings make significant impacts on time saving. These changes will improve the competitiveness of global firms and will give consumers greater flexibility. Due to the almost instant correspondence opportunity at the internet, the conventional market research and goods order methods have been replacing the means of internet communication. Both the consumers and suppliers those who do not want to waste time with the bureaucratic necessities and formal correspondence with foreign trade departments of consular sections, they have started moving such activities to the internet.

d) Effects on Language: Owing to its early establishment and current strength in North America, the English language dominates the internet based electronic commerce. So, this fact will –like it or not-, will in a way force the e-commerce beneficiaries to learn English.

e) Effects on Workplace: Electronic commerce has the potential fundamentally to alter the work environment and work experience. Telework and home businesses are two phenomena that are closely tied to the capabilities of information technologies. On the positive side reduced travel time and flexible hours offer personal and environmental

⁷⁵ FRIEDEN K., *Cybertaxation*, p.31

benefits as the lower costs of office space, and the ability to coordinate work projects over greater distances.⁷⁶

There is a very real possibility that developing countries may be constantly playing catch-up with the technologies and policy principles that have been formulated in the developed world. Also, the "digital divide" is hampering the ability of developing economies to be part of the ongoing process in developed economies: of assessing and possibly re-defining the existing rules for global electronic commerce.⁷⁷

The paradox remains, however, that while networked technologies are a great leveller of economic and social structures, they also have the potential to exacerbate the "digital divide" – the gap between the level of e-commerce development in industrial countries and that in countries and organisations standing on the sidelines of the global e-commerce revolution. Internet-based business-to-business electronic commerce creates new market structures that enable business partners to switch allegiances at low cost, since the Internet expands choices and options to suppliers and consumers on an exponential basis. In addition, it enables contracting parties to exchange information, best practices and market feedback in real time. *Countries left out of the loop could experience the costs of severe economic isolation in this highly competitive environment.* Recent findings by Computer Economics, an e-business adviser to corporations, suggest that *while e-commerce will continue to boom in the next decade, Africa, South America and parts of Asia could be left out of the trade revolution.*

Rather than seeing this as a disaster, it could be seen as an opportunity; the technology in itself is neither good nor bad, so we argued, it is the way in which any technology is used which determines both the nature and extent of its benefits. Moreover these benefits do not accrue automatically to everyone in society.⁷⁸ It is clear that fundamental changes are taking place at virtually level of society, prompted by the growth of the internet, e-commerce and other applications of information network.⁷⁹

3d. Potential and the Future

The idea of the "electronic market-place" is certainly not new, but past activity involving electronic transactions has tended to occur in discrete industrial or product

⁷⁶ OECD, *The Economic and Social Impact of E-Commerce*, p.153

⁷⁷ CHARLES Carol, *New Global Rules For Electronic Commerce: Moving the Dialogue Beyond G-8*, usinfo.state.gov/journals/ites/0500/ijec/giic3.htm,

⁷⁸ EU Commission, *Building the European Information Society for Us All*, Final Policy Report p.2

⁷⁹ OECD, *The Economic and Social Impact of E-Commerce*, p.154

clusters, normally centred around a significant organisation, such as a leading firm, or government agency. The use of ICT to provide a direct, general interface between a wide range of customers and a wide range of products is a more recent development, spurred on in large part by the diffusion of data networking systems, and, in particular, by the tremendous recent growth in the Internet in corporate as well as individual contexts.⁸⁰

Electronic Commerce is a marriage between a rapidly evolving technical environment and an increasingly pervasive set of ideas as to how markets should function.⁸¹ E-commerce is in its infancy because it represents less than 1% of retail sales. Also, only 2.3% of the world's population is on-line. But, the growth potential is great. The US Department of Commerce projects that e-commerce will soon grow to hundreds of billions of dollars annually.⁸² The effects of mature or maturing Electronic Commerce applications on many types of inter-corporate commercial relationships have been significant for some time.⁸³

The Internet and its associated "e-commerce" activities have been evolving at a rapid pace, raising many important issues for policymakers at all levels of government.⁸⁴

*Without a global definition, quantifying e-commerce and predicting its growth are inexact.*⁸⁵ As a result, there are difficulties in assessing the commercial potential of the Internet and electronic commerce.⁸⁶ Many believe that the Internet has the potential to become a basic vehicle for the delivery of almost any kind of electronic service.⁸⁷ Although the reliability of surveys and projections are always open to question, it is the considered view that they are broadly indicative of actual trends – indeed; in some cases (media services for example) they may actually understate the growth potential. An increasing number of firms are using Web-sites to disseminate product information, or to facilitate product support and logistics processes with existing customers and suppliers.

In less than a decade, Internet-derived sales and advertising (also known as **e-commerce**) have gone from being virtually non-existent to billions of dollars in

⁸⁰ Sacher Report p.21

⁸¹ Sacher Report p.22

⁸² NELLEN Anette, *Overview to Electronic Commerce Taxation*, December 2001, p.45, cob.sjsu.edu/factstaff/NELLEN_A/ECOMM.pdf

⁸³ Sacher Report p.22

⁸⁴ CTO, *California Tax Policy and the Internet* p.1

⁸⁵ UK's Taxagenda p.14

⁸⁶ Sacher Report p.22

⁸⁷ Sacher Report p.22

business⁸⁸. Today it can be said easily that a good level of trading cannot be survived without an efficient use of communication technologies particularly the Internet.⁸⁹

In 1998 it was estimated that \$43 billion of business-to-business e-commerce was transacted world-wide, and it has been predicted that this would increase to \$300 billion by 2002⁹⁰ and may approach to one trillion dollars by 2003-2005.⁹¹ E-commerce between businesses and consumers is less significant at present, with an estimated \$7 billion world-wide in 1998, but expected to grow to perhaps \$80 billion in 2002.⁹² According to Forrester Research, on a world wide basis, under optimistic scenarios the trade of goods or services where the final order is placed over the internet may reach as high as 3.2 trillion dollars, or 5% of all global sales. Even under more conservative assumptions, e-commerce is likely to reach nearly 2 trillion dollars in 2003.⁹³

The significance and growth potential of Electronic Commerce is linked interactively to the broader socialisation of the electronic networking environment, a phenomenon that looks certain to proliferate with each generation. Electronic Commerce will not emerge all at once in a standardised form, and it will progress differently according to the requirements of particular industries.⁹⁴

Currently the vast majority of e-commerce takes place between businesses, but it is predicted that e-commerce sales to private consumers will grow rapidly as more individuals gain access, experience and confidence in its use. While both are expected to grow, business to business transactions are anticipated to maintain their predominance. The value of worldwide business-to-business electronic commerce is projected to leap to \$7,300,000 million in the year 2004⁹⁵. While such studies are inevitably speculative, they generally reinforce the dramatic potential of electronic commerce.⁹⁶

An American research agency reports that 'E-commerce has been exploding. Annual U.S business-to-business volume is estimated to reach between \$1.3 trillion and

⁸⁸ EPP Todd, *An Internet Tax Primer*, The Institute of Internal Auditors theiia.org/itaudit/index.cfm?fuseaction.html/index 1

⁸⁹ DAUPHINAIS, W., *CEO'ların Bilgeliği*, Sistem Yayıncılık, Ocak 2002, İstanbul, p.218

⁹⁰ UK's *Taxagenda* p.15

⁹¹ OECD, *The Economic and Social Impact of E-Commerce*, p.12

⁹² UK's *Taxagenda* p.15

⁹³ FRIEDEN K., *Cybertaxation*, p.9

⁹⁴ Sacher Report p.22

⁹⁵ CHARLES Carol, *New Global Rules For Electronic Commerce: Moving the Dialogue Beyond G-8*,

\$2 trillion by 2003, up from an estimated volume of approximately \$100 billion to \$150 billion in 1999. Retail e-commerce is expected to reach between \$100 billion and \$200 billion by 2003.

Regardless of its exact magnitude, Internet and e-commerce activity is extensive and rapidly growing, with similar trends expected for the future as this new technology continues to evolve and expand in scope.⁹⁷

To be sure, *there are constraints to the commercialisation of cyberspace*. A vast majority of households in the world *do not have computers* with which to access the internet. Most households *that do have internet access do not have broad band connections*, which means that their current use is limited by slow downloading speeds that do not have adequate bandwidth required for either efficient web shopping or online enjoyment of pictures and video. Moreover there myriad of other issues such as *privacy, security and affordability* that needs to be addressed before e-commerce realise its vast potential. Nonetheless, such potential obstacles are likely to be overcome in the near future.⁹⁸

As a conclusion, *still small in economic terms, e-commerce has the potential to accelerate existing trends and introduce new ways of conducting business, organising work and interacting in society*. Although there are optimistic and pessimistic predictions, at this point further research needed in order to see more clearly the future potential⁹⁹ but under the light of the current potential and the development acceleration, it will not be a fortune telling to say that e-commerce activities will dominate the vast majority of all business transactions, within at least less than a decade.

CHAPTER 4.. E-COMMERCE AND LAW

Commerce on the Internet could total tens of billions of dollars by the turn of the century. For this potential to be realised fully, governments must adopt a non-regulatory, market-oriented approach to electronic commerce, one that facilitates the emergence of a transparent and predictable legal environment to support global business and commerce.¹⁰⁰ However, generally laws have not been drafted with e-commerce in mind. As a result, they can apply in an unpredictable manner and, in light of the unique nature

⁹⁶ CTO, Taxation of Cyberspace, p.2 -p. 3 caltax.org/ANDERSEN/contents.htm

⁹⁷ *ibid*, p.4

⁹⁸ FRIEDEN K., *Cybertaxation*, p.11

⁹⁹ OECD, *Secrets of E-Commerce*, p.24

¹⁰⁰ Sacher Report, p.13

of e-commerce; it can be difficult to determine how and when they will apply.¹⁰¹ Official decision makers must respect the unique nature of the medium and recognise that widespread competition and increased consumer choice should be the defining features of the new digital marketplace.¹⁰²

Government support for the concept of liberalised electronic services markets must be backed up with real changes in regulatory practices. Badly conceived de-regulation and re-regulation can provide new forms of protection to existing monopolies, and can be worse than preserving the *status quo*. The Internet, as an essential infrastructure component of the information economy, promises to provide a state's industry a global competitive advantage. This advantage should not be jeopardised by inappropriate electronic commerce regulation.¹⁰³

As a matter of urgency, governments need to clarify the legal definitions, practices and structures that pertain to commercial activities in an electronic environment, and to seek multilateral agreements on critical legal matters, especially the laws regarding residency, agency, liability, auditability, control of databases, unauthorised use of databases and data protection. Where appropriate, governments should adjust existing laws and regulations so that they apply to "intangible" as well as "material" product environments.

Recognising the special characteristics of the commercial environment provided by the Internet, an internationally agreed legal definition is urgently required as to where commercial transactions on the Internet are deemed to have taken place.¹⁰⁴ *The fact that a website is available and can be accessed from any country means that, hypothetically, the laws of every jurisdiction in the world potentially may apply.*¹⁰⁵

Many businesses and consumers are still wary of conducting extensive business over the Internet because of the lack of a predictable legal environment governing transactions. This is particularly true for international commercial activity where concerns about enforcement of contracts, liability, intellectual property protection, privacy, security, taxation and other matters have caused businesses and consumers to

¹⁰¹ Clayton UTZ Seminar Papers, *Electronic Commerce - Legal issues*, July 1998, gtlaw.com.au/t/publications/ec980709

¹⁰² Sacher Report p.13

¹⁰³ Australian Tax Office (ATO), *Tax and the Internet*, Second Report, December 1999, p.172 ato.gov.au/content/bussiness/Downloads/ecommerce_tati2.pdf

¹⁰⁴ Sacher Report p.14

¹⁰⁵ KLIMT S., *A Guide to Electronic Commerce*, Clayton UTZ Seminar Papers

be cautious.¹⁰⁶ So it is crucial to make a rapid and fair regulation in the internet and e-commerce area.

4.a. Principles for Regulatory Arrangements

Most of the legal and regulatory mechanisms currently being applied by governments to commercial activity were conceived in an era before the advent of advanced electronic communication systems. The majority of these mechanisms are national in orientation. Even where international instruments and institutions exist, their main function is to support the sovereign rights of national governments. Moreover, frameworks of commercial policy, law and regulation are still oriented overwhelmingly to trade in tangible goods. *Electronic Commerce has the propensity to ignore sector and national boundaries, and it tends to accentuate the intangible aspects of commerce over the tangible aspects.* Electronic Commerce presents many fundamental challenges to the policy framework, especially where the enforcement of legal and regulatory provisions is concerned.¹⁰⁷

The global networked economy needs increasingly flexible legislative solutions to the challenges posed by rapid technological change. These solutions must be formulated on the basis of international dialogue among various stakeholders in the information revolution, including the private sector, national governments, international organisations and consumer groups.¹⁰⁸

Governments can have a profound effect on the growth of commerce on the Internet. By their actions, they can facilitate electronic trade or inhibit it. Knowing when to act and -- at least as important -- when not to act, will be crucial to the development of electronic commerce. But as a result of nature of the electronic market place the private sector has a very important leading role and this role must also be protected in legal regulation of Electronic Commerce activities.

Any global approach or framework needs to be flexible enough to support the growth of the information economy, encourage trade and investment flows, create jobs, and provide consumers with the benefits of competition, while encouraging a stable, secure environment for electronic transactions. Partnership with the private sector and international organisations such as World Intellectual Property Organization, the World

¹⁰⁶ Whitehouse, *A Framework for Global Electronic Commerce*, July 1997, p.2

jpub.com/cyberethic/oneto.cfm,

¹⁰⁷ Sacher Report, p.67

Trade Organization, Organization for Economic Cooperation and Development and UNCITRAL is essential¹⁰⁹ in creating an efficient legal atmosphere for e-commerce.

The European Union stressed the need for regulatory arrangements for electronic commerce in its Communication clearly; 'The Single Market framework has proved its worth for traditional forms of businesses. It must now be made to work for electronic commerce. Building trust and confidence among businesses and consumers implies the deployment of secure technologies (such as digital signatures, digital certificates and secure electronic payment mechanisms) and of a predictable legal and institutional framework to support these technologies. In order to allow for electronic commerce operators to reap the full benefits of the Single Market, it is essential to avoid regulatory inconsistencies and to ensure a coherent legal and regulatory framework for electronic commerce at EU level.

Regulatory responses, where appropriate, need to be addressed at every step of the business activity, from the establishment of business, to the promotion and provision of electronic commerce activities, through conclusion of contracts, to the making of electronic payments. 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.

Considering the essentially transnational nature of electronic commerce, global consensus needs to be achieved. The Commission will actively pursue international dialogue, involving government and industry, in the appropriate multilateral forums, as well as bilaterally with its main trading partners.¹¹⁰

In its Report on A Communication 97(157) The European Parliament stressed some essential characteristics of electronic commerce regulations for EU. The Parliament stated briefly 'Development of a regulatory environment for electronic commerce, considering the speed of its development, has to be flexible, allow for quick adaptations and take into account the developments of the market, governments should encourage and support industry self-regulation wherever appropriate, unnecessary regulation of commercial activities which distort development of the electronic market place so should be avoided.'

¹⁰⁸ GIIIC- Dialogue Beyond G-8

¹⁰⁹ *ibid*

¹¹⁰ EU Commission, *A European Initiative on Convergence, Telecommunications*, Com97(157)

Also it recommended key features for new legal framework. As “it is important that new legislation is not done just for the sake of regulation, it has cover all the Single Market freedoms and take into account the realities of business, as well as meeting the general interest objectives effectively. The legislative framework should take into account the need for freedom of choice. Governments and EU institutions should take into account input from industry, consumer associations and other interest groups while setting up a legal and regulatory environment for electronic commerce. *The regulatory framework should not hinder the rapid development of electronic commerce and must therefore be flexible and ensure technology neutrality and be beneficial for both suppliers and users.* It must also promote interoperability between systems through standardisation. *Over regulation must be avoided.* Some of the issues must be solved by means of new legislative proposals, in most cases at European level and also at an international level.¹¹¹

The US Government also laid down similar principles for regulations in its paper named “Framework for Global Electronic Commerce”. As a summary these are cited briefly below;

1. The private sector should lead: Though government played a role in financing the initial development of the Internet, its expansion has been driven primarily by the private sector. For electronic commerce to flourish the private sector must continue to lead. Accordingly, governments should encourage industry self-regulation wherever appropriate and support the efforts of private sector organizations to develop mechanisms. Where government action or intergovernmental agreements are necessary, on taxation for example, private sector participation should be a formal part of the legal policy making process.

2. Governments should avoid undue restrictions on electronic commerce: Unnecessary regulation of commercial activities will distort development of the electronic marketplace. Accordingly, governments should refrain from imposing new and unnecessary regulations, bureaucratic procedures, or taxes and tariffs on commercial activities that take place via the Internet.

3. Where governmental involvement is needed, its aim should be to support and enforce a predictable, minimalist, consistent and simple legal environment for commerce: Where government intervention is necessary to facilitate electronic commerce, its goal should

¹¹¹ Economic and Monetary Affairs Committee Report on ‘a European initiative in Electronic Commerce’, europa.eu.int/ISPO/legal/ecommerce/oj/1998/1998c407/pe_223_962.fr.pdf

be to ensure competition, protect intellectual property and privacy, prevent fraud, foster transparency, support commercial transactions, and facilitate dispute resolution. In these cases, governments should establish a predictable and simple legal environment based on a decentralised, contractual model of law rather than one based on top-down regulation.

4. Governments should recognise and act according to the unique qualities of the Internet: The genius and explosive success of the Internet can be attributed in part to its decentralised nature and to its tradition of bottom-up governance. Electronic commerce faces significant challenges where it intersects with existing regulatory schemes. We should not assume, for example, that the regulatory frameworks established over the past sixty years for telecommunications, radio and television fit the Internet. Regulation should be imposed only as a necessary means to achieve an important goal on which there is a broad consensus. Existing laws and regulations that may hinder electronic commerce should be reviewed and revised or eliminated to reflect the needs of the new electronic age.

5. Electronic Commerce over the Internet should be facilitated on a global basis. The Internet is emerging as a global marketplace. The legal framework supporting commercial transactions on the Internet should be governed by consistent principles across state, national, and international borders that lead to predictable results regardless of the jurisdiction in which a particular buyer or seller resides.¹¹²

4.b..Legal Issues related to e-commerce

It is clear that currently a comprehensive legal framework for international electronic commerce and an efficient infrastructure to support such a framework (electronic signatures, document registries, dispute mechanisms, consumer protection etc) does not exist.¹¹³ It should be noted that small value electronic commerce may proceed with vigour before the legal issues are resolved. However it seems unlikely that businesses would engage in large value electronic commerce where the rules and obligations are uncertain.¹¹⁴

When we examine the electronic commerce under existing legal arrangements we see that existing rules are not correctly sufficient to arrange all the activities those

¹¹² Whitehouse, A Framework for Global E-Commerce

¹¹³ Australian Tax Office (ATO), *Discussion Report of the ATO Electronic Commerce Project*, p.36, ato.gov.au/content/businesses/downloads/ECOM_P1.rtf

¹¹⁴ *ibid*, p.37

occur in electronic arena but we also see that many of the legal problems raised by electronic commerce can be solved by using the existing rules.¹¹⁵ In many cases there has only been a need for contemporary interpretation of existing rules.¹¹⁶ But also there has been very extraordinary and unusual problems presented by the new technology and the electronic commerce depends on it.¹¹⁷ There are missing legal issues in the area of electronic commerce, such as liability, definition of the place of establishment for service providers in the on-line environment, commercial communications, regulated professions, patents, trademarks and domain names¹¹⁸ etc.

In order to clarify the regulatory framework for these issues and to safeguard the rights of the users of electronic commerce there has also been a need to devoted efforts. While studying the alternative regulation models, there generally accepted options prevail;

One option would be to continue to work with existing definitions, recognising that these remain valid for the majority of services offered and to extend, where appropriate, the principles underpinning current regulation, whilst adapting the way in which it is applied to take account of the specific characteristics of the "new" services.

A second option might be the creation of a separate category of "new" services to co-exist with existing definitions.

A third option would be the adaptation of current definitions used in telecommunications, and/or broadcasting to reflect current trends and developments.¹¹⁹

Today the international trend about the legal environment of electronic commerce is the first option.

As an overlook to the newly presented problems by e-commerce to the legal arena we can mention the following;

Competition: Electronic commerce is transforming the marketplace by changing firms' business models, by shaping relations among market actors, and contributing to changes in market structure. Given the dynamic structure of the process it will make changes on firms' competitive abilities.¹²⁰ Competition arrangements will have to address new types of anticompetitive practises. An open competition policy in the provision of facilities, products and services has to be ensured. The state of the

¹¹⁵ SINAR Hasan, *Internet ve Ceza Hukuku*, İstanbul 2001, p.67

¹¹⁶ *ibid*

¹¹⁷ ÖZSUNAY Ergun, *Elektronik Sözleşmelerde Türk Hukukuna ilişkin Çözümler*

¹¹⁸ Pe223 962

¹¹⁹ EU Commission, *Greenpaper*

competition situation and the barriers to entry should be assessed. It is important to keep barriers low in this new market.

Security, privacy and payment systems are related issues as they are concerned with the unlawful access to confidential data, which opens the possibility of crime and fraud. E-commerce has brought with it a number of new privacy challenges. One of the most commonly quoted impediments to the full development of electronic commerce is the lack of consumer confidence in the integrity of communications on-line and fears as to how information provided electronically may be used. For instance, consumers may be unwilling to provide personal information over the internet because of fears the information may be interrupted or otherwise used inappropriately.¹²¹ The issue of anonymity also needs to be addressed in the context of privacy. The most effective known means of user defence against on-line crime are strong encryption technologies. Digital signatures and certificates are needed to create user confidence. This could be done through the use of cross border legal recognition of digital signatures, preferably on the basis of home country control and mutual recognition. As digital signatures will be used everywhere in society, the protection of citizens should be given due attention. The rights of individuals to maintain anonymity should be respected and not unnecessarily restricted.

Today in practice the digital is the most frequently used technology for electronic signatures. The development of e-commerce relies, to a large extent, on the trust and security that users feel in electronic communications. This is mostly in relationship with electronic signatures.¹²²

Payment systems: Internet users usually regard speed of transaction the next most important consideration after price, how safe and fast will the payment be made when deciding who to buy from. Parallel to developments in e-commerce, various payment systems such as credit cards, electronic money, letter of credit etc. have been developed and utilised¹²³. Further development and use of smart cards and e-money will make payments through the Internet easy and secure, building the necessary confidence among users.

Contract law: The law in relation to contracts is complex and, in the case of e-commerce, there is the added problem of applying established concepts (which have

¹²⁰ OECD, Economic and Social Impact of E-commerce, p.24

¹²¹ KLIMT S., A Guide to Electronic Commerce, Clayton UTZ Seminar Papers.

¹²² ITC, Secrets of E-commerce, p.84

¹²³ ITC, Secrets of E-commerce, p.128

traditionally been developed in relation to written contracts) to contracts formed in cyberspace. Various aspects relating to the creation of a contract will need to be examined in order to ensure that contracts formed electronically are valid and binding.¹²⁴ The conclusion of contracts electronically in a transfrontier and networked environment brings about a number of important questions which will have to be addressed in order to facilitate electronic commerce transactions across borders. For instance, the determination of where and when an electronic contract is concluded and which country's law is applicable, could be addressed differently by the states. Generally the law that will apply to a contract is the law of the jurisdiction in which the contract is formed. The question is where is the contract is formed where the offer and acceptance is communicated electronically, such as over the web? This can be difficult to establish and the answer may differ depending on whether the acceptance is on-line real time. There may be difficulties in establishing the identity of a contracting party. Although the identity of the person responsible for the terminal from which an acceptance was sent can be established, that person may not have been the person that sent the acceptance.¹²⁵ These questions, which go beyond the legal recognition of digital signatures, should be clarified in order to facilitate electronic contracting.

Intellectual Property Rights (IPRs) should be protected by adapted copyright rules. These rules should be enforceable and balance interests of rightholders and users. If the site owner wishes to display or sell any material in which a third party owns copyright (whether text, images, software, data or the like) it must ensure that it has the licence of the copyright owner to do so in every country in the world. It should also be pointed out that it may be difficult for the site owner to restrain any subsequent infringement of the copyright by the purchaser. For example, it will be difficult to prevent a purchaser from downloading text, images, software or data to a third party.

Most jurisdictions also have legislation protecting trademarks. Accordingly, the site owner must ensure that there is no infringement of trade marks on the website. The particular difficulty with trademarks is that they may be registered to different entities in different jurisdictions.¹²⁶

Exercise of regulated professions: Certain aspects of regulated professions (lawyers, accountants and doctors etc.) in the networked environment need to be addressed in

¹²⁴ KLIMT S., A Guide to Electronic Commerce, Clayton UTZ Seminar Papers

¹²⁵ *ibid*

¹²⁶ *ibid*

order to facilitate the offering of some of these services, such as legal advice, over the network.

Commercial communications (advertising, sponsorship, sales promotion etc.) There are a number of questions in this area that need to be clarified in the on-line environment. For instance: how should a commercial web-site be treated - is it advertising, direct marketing or simply a shop window?

Liability: The issue of liability is often raised in the copyright context. There is no doubt, however, about the horizontal nature of this problem. The liability of Internet service and access providers may arise in multiple areas - copyright, trademarks, misleading advertising, protection of personal data, product liability, obscene content, hate speech etc.

Crime and Fraud: As argued above fight against cybercrime has to be done mainly by the use of secure technologies such as encryption, but liabilities, crimes and penalties also have to be defined. Issues on registration, jurisdiction, contract law, advertising, etc. have to be solved. At international level, police and justice co-operation has to be improved. An international system of electronic arbitration would also be highly desirable to help solving disputes.

Taxes and Tariffs: Where a company is engaged in business in a number of jurisdictions, it will be necessary to determine in which of those jurisdictions it will be liable to tax. Generally, this will depend on whether it has a "taxable presence" in a jurisdiction.

E-commerce raises particular issues in relation to whether an entity has a taxable presence. For example, maintaining a web server or a website in a particular jurisdiction may be sufficient to establish a taxable presence in a jurisdiction (depending on the legislation of that jurisdiction).¹²⁷

No new taxes should be imposed on electronic commerce, and that a bit tax which would negatively affect electronic commerce and could give rise to double taxation has to be avoided. Taxation issues should be agreed internationally and tax neutrality should be pursued. Furthermore, burdensome regulation on taxation should be avoided.

It is clear that electronic commerce opens up new legal problems in almost all fields of law, particularly in commercial law, law of nations, law of contracts, criminal

¹²⁷ KLIMT S., A Guide to Electronic Commerce, Clayton UTZ Seminar Papers.

law, tax law, procedural laws etc. This brings a need to a very careful, dedicated legal study.

4c. Tax Law and Electronic Commerce

Electronic commerce raises some issues concerning the existing law and its interpretation as well as concerns about the possible migration of business to tax havens. The widespread adoption of electronic commerce will increase the number of businesses engaged in international trade. *Increased participation in international trade raises some challenges for tax administrations.*¹²⁸

For taxation to be effective a tax administrator must be equipped with a number of fundamental requirements which apply, to some degree, to all historical, contemporary and theoretical types of taxation. The fundamental requirements are: a)Jurisdiction; b)Identification; c)Information; and d)Collection Mechanisms.¹²⁹ Electronic Commerce has profound legal and technical effects on all of these requirements.

There is an international debate on the changes to taxation systems that electronic commerce may bring about.¹³⁰ The taxation rules currently in force do not take account of technological progress in the delivery of services, and changes are necessary in order to prevent loss of tax revenue and distortion of competition resulting from the current legislation.¹³¹ In fact, some of this current debate had its roots in longstanding tax issues, such as collection of use tax on mail order sales, sourcing of income, and characterisation of revenues from software transactions. Arguably, the Internet has just highlighted these and other longstanding tax issues, and created a few new ones. Perhaps the Internet and e-commerce serve as a "wake-up call" that it is time to improve and update our existing tax systems as we pick up the pace in moving from the industrial era to the information age.¹³²

The global nature of the Internet creates challenges for tax jurisdictions and the current source, residency, permanent establishment and allocative rules. It is likely that

¹²⁸ Australian Tax Office (ATO), *Tax and the Internet*, Second Report, December 1999,p.171
ato.gov.au/content/bussiness/Downloads/ecommerce_tati2.pdf

¹²⁹ ATO, Discussion Report of the ATO Electronic Commerce Project, p.38

¹³⁰ Bolkestein Frits, *A Changing Approach to Taxation with the Development of E-Commerce*,14 Sept 2001

¹³¹ EU Commission, *Working Paper on Indirect Taxes and E-Commerce*, p.4

the existing international rules will need to be substantially revised in light of electronic commerce. There are also concerns about the increased scope for tax planning, especially using tax havens, and for increased accidental non-compliance, as small to medium businesses engage in international trade and become subject to international taxation obligations with which they may not be familiar.¹³³

WHY THE INTERNET AND E-COMMERCE RAISE TAX ISSUES?

As argued in details above, e-commerce represents a new business model. As such, it creates some challenges to tax systems that were designed with a different model in mind.¹³⁴ Some of the key reasons why e-commerce raises tax issues are explained as follows:

1. Location: Existing tax systems tend to determine tax consequences based on where the taxpayer is physically located. The e-commerce model enables businesses to operate with very few physical locations. An online vendor can easily sell to customers throughout the world from a single physical location. Also, some business assets, such as servers, are not necessarily tied to a single physical location, but can easily be relocated without any interruption to business operations. That is, the location of the server is not relevant for business purposes and thus, may not be a logical taxing point.

2. Nature of Products: E-commerce allows for some types of products, such as newspapers and music CDs, to be delivered in digitised (intangible) form, rather than in tangible form. The nature of products can also raise income tax issues regarding the type of revenue generated and how it is to be reported, as well as whether digitised products are subject to traditional inventory accounting rules.

4. New Types of Assets: Some of the new assets created by commercial use of the Internet are domain names (URLs) and web sites. For income tax purposes, issues exist as to how to treat the costs of creating or acquiring such assets, as well as the characterisation of any gain or loss generated upon disposition of the asset. Sellers of such assets may face uncertainty in the law as to how to characterise the gain or loss generated from the disposition (capital or ordinary).

5. Remote Workforce: The workforce of an Internet company may be scattered throughout a state or country, rather than working in a single work location together.

¹³² NELLEN Anette, *Electronic commerce; To Tax or Not To Tax*, p.2
cob.sjsu.edu/factstaff/NELLEN_A/BoaltUT6_01.pdf

¹³³ ATO, Discussion Report of the ATO Electronic Commerce Project, p.7

¹³⁴ NELLEN A., *To Tax or not to Tax*, p.13

This can raise issues as to whether the presence of the employee in a particular state creates tax obligations for the employer in that state.

6. Making Optimal Use of the Internet May Challenge Old Rules: One area where use of the Internet has potentially raised some tax issues involves how some tax-exempt organisations are using the Internet.

7. Nature of Transactions: The Internet allows for paperless transactions and the potential for the use of electronic cash. This raises administrative concerns for the Internal Revenue Service as to whether transactions were properly reported, whether an audit trail exists, and whether new reporting rules are needed.¹³⁵

The immediate task is to identify the problems which would arise in the field taxation from the growth of e-commerce and to review current legislation. It is clear from the outset that a purely legislative approach to taxing e-commerce is not the answer. Current taxing legislation is designed to cope with existing forms of economic activity and it was always likely that new techniques might be needed to deal with e-commerce. In many instances, the existing mechanisms and legal base will ensure that taxes will continue to be collected but there is a need to address the problems likely to be caused by an increase in the scale of transactions. Elsewhere however, serious shortcomings in the existing protocols surrounding e-commerce will cause difficulties for tax administration if not rectified.¹³⁶ The key to success is the creation of an open competitive global trading area which delivers choice for the consumer and new markets for business. To achieve this it is needed to create an environment, which nurtures dynamism and creativity, built upon the foundations of a secure legal tax environment.¹³⁷

A creative approach is necessary for providing a clear and predictable framework, within which e-commerce can flourish, but above all barriers must be removed and uncertainty resolved. It is essential that the business community is at the front of this process and is not hampered either by uncertainty about the future tax regime or by tax rules which fail to give a level playing field.¹³⁸ The international communication developments and growth of electronic commerce hold out new opportunities for the entire global community. But they also exert pressure, both on

¹³⁵ NELLEN A., *To Tax or not to Tax*, see p.13-15

¹³⁶ EU Commission, *Interim Report on the implications of electronic commerce for VAT and Customs*, XXI/98/0359, 3.4.1998, p.27

¹³⁷ Bolkestein F, *Is Europe Ready for the New Economy?* 27 March 2000, europa.eu.int/

enterprises and on countries, to maintain and improve their competitive position. The Internet in particular has the potential to increase tax competition, by making it much easier for multinationals to shift their activities to low tax regimes.¹³⁹ Because of this, e-commerce will require enhanced international co-operation between tax administrations.

So there have been several issues which have to be reconsidered and evaluated by law of taxation.

Here, two guiding principles emerge for careful consideration: Firstly, *the quality of the regulatory framework of taxation should be improved*; and secondly; *the effectiveness of the legal framework should be enhanced*.¹⁴⁰



¹³⁸ *ibid*

¹³⁹ Bolkestein F, *VAT on Electronic Commerce*, 20 Sept 2000, europa.eu.int/ISPO/

¹⁴⁰ BOLKESTEIN F. *'Is Europe Ready for the New Economy?'*

PART 2- ELECTRONIC COMMERCE AND EMERGING LAW OF TAXATION

CHAPTER 1.. DISCUSSIONS ON TAXATION OF E-COMMERCE:

For the past several years, some policymakers have argued not taxing the Internet so that it, along with e-commerce, can grow unencumbered by taxes¹⁴¹. Many long time Internet users believe the Internet should remain free of governmental regulation or taxation¹⁴²

It has further been argued by government officials and some businesses that the Internet and e-commerce need to be taxed in order to protect government revenues and to "level" the playing field among all types of businesses and taxpayers.¹⁴³

In addition, much study and discussion has taken place and continues among governments and businesses to understand the application of existing tax rules and systems to the new business model of e-commerce and to new types of transactions and assets presented by the operation of the Internet. These discussions have been at the international, national, state and local levels.¹⁴⁴

However, even among those who argue that e-commerce is commerce and should be taxed, the ideas for how to effectively tax it are diverse.¹⁴⁵ Some of the authors suggest applying new taxes on interactive digital traffic. This new tax would be similar to a gasoline tax or paying a toll on a bridge or toll road in physical transportation. Moving from the old highway to the metaphor of the new highway, proposal is to tax the digital traffic on the Information Highway.¹⁴⁶ Some of others advocate the adoption and revise of existing taxes will be adequate to tax the electronic commerce.¹⁴⁷

We need a deeper outlook to the discussions in order to clarify the issue. Careful consideration of some basic points will be helpful to do this:

¹⁴¹ NELLEN A., *To Tax or Not to Tax*, p.2

¹⁴² CTO, *The Taxation of Cyberspace*

¹⁴³ NELLEN A., *To Tax or Not to Tax*, p.2

¹⁴⁴ *ibid*, p.2

¹⁴⁵ *ibid*, p.3

¹⁴⁶ Arthur Cordell, *New Taxes for A New Economy*

¹⁴⁷ Bolkestein F., *VAT on E-Commerce*

Globalisation makes the cross-border movements in goods, capital and labour less transparent. Companies and individuals are therefore able to exploit tax differences between countries. Electronic commerce and globalisation are, and will continue to be a challenge to tax collectors throughout the world.¹⁴⁸ E-commerce makes the tracing of transactions and thus the taxing of goods and services sold and distributed via the Internet almost impossible. As a result, state and national governments' tax bases are, or are at risk of, being eroded.

1.a. No Taxation for E-Commerce

As the Internet has grown, the competition between profit-seeking businesses, both service providers and companies selling computer-related goods, such as software, and companies marketing products via the World Wide Web, has been intense¹⁴⁹. Internet service providers, direct marketing, technology companies -- just about everybody except the state and local governments -- all oppose the idea of imposing new taxes on the Internet¹⁵⁰

Supporters of the idea of the tax free electronic commerce --at least for a time-- base their opposition to taxes on some arguments:

Taxes will hinder entrepreneurial development of the Internet, particularly the efforts of the many fledgling companies operating in this area. "It may bring us to a screeching halt in this area and severely limit the potential development of electronic commerce," says Bruce Hahn of the Computing Technology Association, which lobbies on behalf of 7,500 computer businesses.¹⁵¹ They are all deeply concerned that "a tax on the Internet and e-commerce will serve to hinder growth in this important sector at the time when it can least afford it. The proper role of Government in this emerging industry is to encourage its growth. It would be a grave mistake on our part to start taxing Internet commerce before it has even had a chance to establish itself."¹⁵²

No Taxation without representation rule : In order to have a nexus in a taxing jurisdiction , a taxpayer needs to have an office in the taxing jurisdiction, or at least there must be sales representatives , technicians performing occasional services for the

¹⁴⁸ *Taxing Cyberspace ;Eroding Tax Base*, meritbbs.unimaas.nl/cybertax/taxbase.html

¹⁴⁹ BASS Vickie and MANNIX Charles, *Taxes and the Internet: The Anti- Tax Case* icgs.harvard.edu/iip/stm308m/project/internet.htm

¹⁵⁰ *ibid*

¹⁵¹ TERENCE Samuel, *Tax Freedom for Internet Worries States, Cities,*" St. Louis Post Dispatch, Feb. 5, 1998.

¹⁵² NELLEN A., *To Tax or Not to Tax*, p.4

taxpayer.¹⁵³ It means there must always be an attributional nexus in order to tax an income, sale, or use. There was little revolution a couple of hundred years ago related to some issue surrounding "taxation without representation." Who is "representing" a company that exists only on the Internet?¹⁵⁴

The Internet is currently subject to taxation in the same manner as catalogue, mail order and TV sales, communication activities on the Internet are taxed in the same way as communication services and equipment are. The bit tax would trigger double taxation, would thus lead to double taxation.¹⁵⁵ Also, further taxes on e-commerce are regressive by nature and only serve to widen the "digital divide" -- the gap between the level of e-commerce development in industrial countries and that in countries and organisations standing on the sidelines of the global e-commerce revolution¹⁵⁶ or will cause an unintentional double taxation.

Despite the meteoric rise in electronic commerce over the past five years, traditional state sales tax revenues continue to grow, revenue losses are uncertain.¹⁵⁷ So there has been no need to worry about the erosion of tax revenues because of electronic commerce.

A no-taxation system of Internet purchases sets up a natural constituency to fight for lower tax rates - those 'unfairly' taxed brick-and-mortar businesses and their customers. These firms/customers will be the engine to lower tax rates. To stay competitive they will lobby the taxing authorities to push sales taxes down. This is the real reason why we should continue to push for a permanent ban on Internet commerce taxes.¹⁵⁸

The Internet "should be allowed to grow in a free-enterprise environment with as little government interference as possible," says John Boffa, executive director of the Internet International Trade Council, a Washington-based trade group representing ISPs. He does not argue not to tax the net at all, he says: "The Internet is a child, and when you have a child, you don't impose a lot of rules and regulations on it until it has a chance to define itself."¹⁵⁹

¹⁵³ FRIEDEN K., *Cybertaxation*, p.273

¹⁵⁴ FLEISHER Trey, *Take a stand Against Internet Taxes*, nointernettax.org/index.cfm?Page_Press

¹⁵⁵ *Taxing Cyberspace-Eroding Tax Base*

¹⁵⁶ GIIC, *Dialog Beyond G-8*

¹⁵⁷ FLEISHER Trey, *Read My Mail No New Taxes*.

¹⁵⁸ FLEISCHER Trey, *Take a stand against Internet Taxes*

¹⁵⁹ AMY Rogers & DARRYL K. Taft, *No Resolution In Sight For Internet Taxation Debate*, *Computer Reseller News Washington*, Mar. 24, 2000, actonline.org/about/0324CRN US

The need for consistent policies across state lines is important for electronic commerce. Because of the international character of it so before taxing it, some international policies and approaches must be more clear. Imposing impatient taxation procedures by states individually might cause inconsistencies and confusion of procedural applications of international taxation of e-commerce.

There are technological difficulties of assigning physical responsibility for aspects of a system that is essentially without physical borders. Governments at first hand must find answers to technological facilities of e-commerce widely, and strive to solve the problems of efficiency, identity, compliance, etc. at technological level. Then, a better taxing regulation would be possible.

Reacting to the growth in electronic commerce as a new revenue source and fearing the erosion of the existing tax base, governments needlessly threaten a nation's future economy.¹⁶⁰

To ensure that the Internet and electronic commerce continue to grow unimpeded by government taxation, defendants of the argument advise governments take affirmative steps to do the following:

- Abstain from any taxes on access to the Internet.
- Avoid your nations from any taxes on electronically delivered goods and services.
- Clearly define nexus to require actual physical presence by the merchant before a state can impose use tax collection and remittance requirements.¹⁶¹

The United States Framework for Global Electronic Commerce states that "The Internet should be declared a tariff-free environment whenever it is used to deliver products or services".¹⁶² The Internet Tax Freedom Act argued that this practice was justified due to the "infant industry" nature of the Internet. *However, as the Internet matures, this argument becomes less tenable.*¹⁶³

¹⁶⁰ FLEISCHER T., *Read My Mail no new taxes*

¹⁶¹ *ibid*

¹⁶² Whitehouse, *A Framework for Global E-Commerce*

¹⁶³ HAL R. Varian, *Taxation of Electronic Commerce*, April 2000, School of Information Systems and Management University of California at Berkeley, internetpolicy.org/briefing/4_00_story.html

1.b.. New Taxes by New Methods for a New Economy

It is likely that taxes will erode with the growth of Internet.¹⁶⁴ A great number of taxable added values will be lost in the flow of the digital traffic.¹⁶⁵

In order to protect the governments' tax revenue and to act fair between traditional and electronic commerce there has been proposal to tax the electronic commerce by a new tax and new method. One high-profile proposal is to tax not the product or service, but rather to tax the transmission of data involved in the transaction.¹⁶⁶ The "bit tax" was originally conceived by Arthur J. Cordell and Thomas Ide in a paper presented at The Club of Rome in December, 1994. In its most recent form, the advocate is Luc Soete, who chaired the High Level Expert Group of International Communications Technology for EU.¹⁶⁷

At a time when the more prudent route of advocating no *new* taxes on commercial Internet activities and are encouraging policies designed to foster its rapid expansion and development, proponents of the "bit tax" have stepped to the fore as the only group to be going in the complete opposite direction.

The proposal for a "bit tax" applied to all interactive digital services (Cordell, A. and T. Ide, *The New Wealth of Nations*, 1997) and based on a simple count of bits flowing over telecommunications lines follows directly from the "information highway" analogy. As in the case of the automobile, when gasoline or bridge tax is paid on physical highways, on the information superhighway digital traffic is taxed per unit of electronic transmission.¹⁶⁸ The tax would be a "bit tax" assessed on the sheer volume of digital bits transmitted. Principal among the objectives of such a tax is the redistribution of the benefits of the information society more equally among the population.¹⁶⁹

Arthur Cordell makes its proposal and defines his theory in his article "New taxes for a New Economy"; 'In my view we need to get consensus on a positive vision of the New Economy. One possible positive vision is that the New Economy will be one where few people work in traditional ways. It will be an economy that is very infotech intensive

¹⁶⁴ SOETE Luc , *Bit Tax Proposal Analysis* , June 1999,meritbbs.unimeas.nl/cybertax/response.html

¹⁶⁵ Arthur Cordell, *New Taxes for a New Economy*

¹⁶⁶ Sacher Report p.53

¹⁶⁷ GOULET Jeanne, Director of Taxes for IBM, *IBM's Response for Bit Tax Proposal*, April 1997, meritbbs.unimaas/cybertax/ibm.html,IBM's Response

¹⁶⁸ High Level Group of Experts(HLEG) , *Building the Information Society For Us All*, Final Policy Report, April 1997, p.42

¹⁶⁹ GOULET J., *IBM's Response for Bit Tax*

and highly productive. If everything else is changing with information technologies and the New Economy, I think the tax system itself deserves a closer look.¹⁷⁰

He goes on his argument; "we are wringing our hands at the lack of tax revenues. As do-it-yourself banking, shopping, libraries, etc. take hold, the number of people displaced increases. Although this adds to the overall productivity of the system, the workers who lose jobs no longer pay taxes".

Over two hundred years ago Adam Smith wrote about the Wealth of Nations. He concluded that wealth was based on the division of labour and the extent of the market. Today we can add something else to society's production function: knowledge, information and communications. The new wealth of nations is to be found in the trillions of digital bits of information pulsing through global networks. These are the physical/electronic manifestation of the many transactions, conversations, voice and video messages and programs that, taken together record the process of production, distribution and consumption in the new economy."¹⁷¹

The suggested new tax is a turnover tax on interactive digital traffic, similar to a gasoline tax or paying a toll on a bridge. Moving from the old highway to the metaphor of the new highway, his proposal is to tax the digital traffic on the Information Highway.¹⁷²

Proposed is an easily administered tax on each digital bit of information; a "bit tax". Whether the digital bit is part of a foreign exchange transaction, a business teleconference, an Internet e-mail or file transfer, electronic check clearance or an ATM transaction, each bit is a physical manifestation of the new economy at work. The bit tax would be applied to value added interactive digital transactions.

The bit tax will be transparent. It will be something metered "out there" and remitted to governments. Automatically collected, it would cause fewer collection problems than most other direct or indirect taxes. Collected by the telecom carriers, satellite networks and cable systems the revenues would flow directly to the national revenue service of the respective country.

The bit tax is one way to begin to deal with the dilemma of increasing productivity and declining employment. It represents a new tax base that is at the heart of the new economy. It is also a new tax base that is growing. It is a tax base that can be easily

¹⁷⁰ Arthur Cordell, *New Taxes for A New Economy*

¹⁷¹ *ibid*

¹⁷² SOETE Luc, *Bit Tax Proposal Analyses*, p.5

identified one where collection is in few hands. In the New Economy it would be a tax that is difficult to avoid.

It is indispensable to develop alternative tax regimes which are more in line with the global nature of the Information Society and the increasingly intangible nature of the goods and services exchanged.¹⁷³

In the case of immaterial information services being exchanged, where notions of value are difficult to estimate or to monitor, such a tax base might well have to become based on the intensity of electronic transmission. The idea of a "bit tax" has led to considerable reaction amongst the press, policy makers and individual Internet users.¹⁷⁴

For IBM, one of the main opponents of implementation of bit tax, "the new tax proposal is long on social theory and short on practical detail. No clear plan of implementation has emerged, leaving many questions unanswered: Which transmission will be subject to tax? How will intranet transactions be handled? How do you handle redistribution of tax revenues among governments? Which jurisdiction will collect the tax, origination vs. termination? How will double tax be avoided? Most countries have an embedded tax or universal services charge already included in the structure of their telecommunications tariffs. The "bit tax" would be additive. A "bit tax" fails this basic principle of taxation because it discourages electronic transmission of information."¹⁷⁵

Also they add to the main arguments an analogy; "Approaching something as big and as complex as the Internet on a bit-by-bit basis surely will lead to a totally inappropriate conclusion."¹⁷⁶

FEI (Federation of Electronic Industry, representing the electronics industries in the UK) adds; "Supporters of the bit tax speak of "information pollution" and suggest that forcing the provider or user of information to pay a tax per bit will reduce the amount of "over-information". "Over-information" is not a problem, but only one advantage of living in a democratic society. Monitoring data for taxation purposes could furthermore be interpreted as an invasion of privacy. Rather than impose yet another tax and further disadvantage consumers and businesses across Europe, the public

¹⁷³ HLEG, *Building the Information Society for Us All*, p.42

¹⁷⁴ SOETE Luc and KAMPF Karin, *The Bit Tax Case for further Research*, Mer 96019 p.2, edocs.unimaas.nl/files/mer96019.pdf

¹⁷⁵ GOULET J., *IBM's Response for Bit Tax*

¹⁷⁶ *ibid*

sector should lead the way in supporting and promoting investment in new technologies.”¹⁷⁷

Perhaps it is not surprising that in the present, global free market environment, any suggestion for a new tax is likely to be greeted with scepticism and to be quickly rejected.¹⁷⁸

The International Communications Round Table "ICRT" (the ICRT as a cross-sectoral group of over 30 International Companies) urges the European Commission and member states to unite in their opposition to proposals to introduce new taxes specifically for electronic commerce. The basis of their argument consists of following:

1-The taxation of Electronic Commerce should be guided by the principle of neutrality and therefore any new forms of taxation are entirely inappropriate.

2-Any bit tax would be difficult - perhaps impossible - to enforce without global unanimity, since without such consensus "bit tax" havens would immediately appear, thereby creating commercial and trading cross border distortions.

3-The counting of bits is technically feasible but the need for specialised software and additional hardware to aggregate the bits and determine their routing for accounting purposes adds a substantial and unwarranted cost.

4-The growth of electronic commerce will enhance, not only employment but also (contrary to some beliefs), the revenues of states via taxes on income and VAT through the new forms of networked business generated. A new bit tax that was inherently difficult to administer, could jeopardise investment in electronic commerce and therefore put at risk the benefits of growth.¹⁷⁹

Committee on Economic and Monetary Affairs and Industrial Policy of EU stresses in one of its reports that "no new taxes should be imposed on electronic commerce, and that a bit tax which would negatively affect electronic commerce and could give rise to double taxation has to be avoided. Taxation issues should be agreed internationally and tax neutrality should be pursued."¹⁸⁰

As a matter of principle, the Sacher Group¹⁸¹ opposes proposals that are oriented to taxing the process of data exchange (the "bit tax"), as unworkable and potentially

¹⁷⁷ Federation of Electronic Industry (FEI), *FEI Position on Bit Tax*, fm6.facility.pipex.com/fei/public/position/bittax.htm

¹⁷⁸ SOETE Luc and KAMPF Karin, *The Bit Tax Case for further Research*, p.3

¹⁷⁹ International Communications Round Table (ICRT), *Position Paper on the Bit Tax*

¹⁸⁰ EU Parliament, *Report on A European Initiative in E-Commerce*, p.22

europa.eu.int/ISPO/legal/ecommerce/oj/1998/1998c407/pe223_962-fr.pdf

¹⁸¹ For further information, see fn.178

discriminatory to Electronic Commerce activities and to normal business communications.¹⁸²

One of the defendants of the applicability of a new tax to electronic commerce, Luc Soete, the chief of the High Level Expert Group of the EU on the subject, evaluated the bit tax in one of the Group's paper and defended himself against the harsh reactions to the proposal in his paper as; "The purpose of this short paper was to bring together some of the main arguments why there is, at least in our view, an urgent need for investigating the feasibility of such a new tax notion. Our hope was not to detract the many "criticasters" but rather that those Internet users, communication experts or policy makers who rejected the idea in an immediate, spontaneous, "cyber-like" fashion, might reflect a little longer on some of the arguments presented here. The volume and the speed of the reactions received so far have not succeeded in convincing us that there is a strong argument for not investigating the issue."¹⁸³

In brief words the negative and positive affects of bit tax may be as follows;

The Positive Aspects of Taxing Transmissions:

1-Governments have historically adjusted the tax base to reflect changes in the economy at large - so why not now?

2-Revenue is being lost as traditional forms of trade are replaced by business in communications media. Taxing transmission would help to recoup government's tax revenues.

3-Tax on information transfer is nothing new; we pay VAT on our phone bills. So why not on Net communications?

4-Proposals recommend a total reassessment of conventional taxation of communications; the bit tax would not double up VAT on phone calls.

5-It may very well reduce congestion on the Internet.

6-A bit tax might help, to some extent, in reducing 'information pollution'. In so far as it would introduce a 'costing' element in Internet use, the bit tax could provide an incentive for more efficient use of electronic information.

¹⁸² Sacher Report p.17

¹⁸³ SOETE Luc and KAMPF Karin, *The Bit Tax Case for further Research* , p.14

7-Many believe that some type of tax will be needed because of lost tax revenues on 'physical' goods. In order to ensure proper tax collection, governments must claim the right to collect, inspect and intervene in Internet transmissions, say some analysts. This clearly challenges privacy. A bit tax does not.

... and the Negative:

1-A transmission tax is in no way related to the economic value of the good. A videoclip sent to a friend, with no commercial value but containing a large number of 'bits' would incur a much higher tax bill than a commercial database made up of fewer bits. The videoclip has no commercial value, if sent via normal mail the videoclip would hardly be taxed at all, while the database would be largely under-taxed by a bit tax.

2-No such tax exists for other methods of information transfer (i.e. fax), - so why would there be any on this one?

3-It is a tax on freedom of speech. It penalises the private user as much as the commercial user, with no differentiation tax-wise between them.

4-It could discourage the development and usage of the Internet resulting in economic inefficiencies. It could give rise to peculiar incentives, e.g. artificially compressing data or maintaining it in analogue form, so as to avoid paying a tax based on bits or bit count. Another economic distortion could be that companies 'build' intra-nets to avoid Internet taxes.

5-The Internet is 'environmentally friendly' in that it reduces the use of paper and other media that incur higher environmental costs. A bit tax might discourage Internet usage and thus have negative environmental consequences.

6-It may be difficult to implement. I.e. bits are difficult to count within statistically shared networks and could be hidden by encryption.

7-If not implemented on a world-wide scale it could lead to distortions in competitiveness. Otherwise, on-line transactions may simply be deferred to a jurisdiction where no such tax exists.¹⁸⁴

¹⁸⁴ *Positive and Negative Aspects of Bit Tax*, meritbbs.unimaas.nl/cybertax/aspect.html

Conclusion

In closing it seems important to emphasise that, as well as the high level expert group (HLEG), research has been proposed on alternative taxation regimes certainly not the implementation of any particular one. The bit tax could be considered as a tax of last resort, applied only if other means are not feasible. As mentioned in the HLEG final policy report "there is a need for more fundamental consideration of and research into alternative taxation systems. The bit tax might be one such alternative, although the detail and implementation require further study."

At this stage, it certainly seems premature to "outright" reject the notion of a bit tax; more information is indeed needed on how electronic commerce will specifically affect national and international tax systems.

The issue is not whether or not a bit tax is adopted but rather that governments acknowledge and act upon the eroding tax base being brought about by electronic commerce and globalisation. In our view, the final aim should be to develop a tax system which ensures that the tax base does not (further) erode while at the same time realising the full potential of the electronic networks. This whole process requires thought, reflection and eventually concerted policy action. Hasty decisions about duty free systems could very well lock countries in to inappropriate standards; this must clearly be avoided.¹⁸⁵

1.c.. Application of Current Taxes for E-Commerce

Historically, the goods we consumed were physical and therefore the production, distribution and consumption of these goods was easily taxable. As our economy becomes more and more characterised by the production, distribution and consumption of intangibles from an economy that was characterised by the production, distribution and consumption of tangibles, it seems relevant to question whether or not the present tax base remains adequate.¹⁸⁶

Historically, the material goods which were distributed and consumed were traceable and taxable. Existing forms of taxation might still be appropriate, but in need of reformulation and/or harmonisation. OECD is the international body best placed to co-ordinate and progress work on taxation matters.

¹⁸⁵ Taxing Cyberspace, *Response for Bit Tax*, meritbbs.unimaas.nl/cybertax/response.html

¹⁸⁶ SOETE Luc and KAMPF Karin, *The Bit Tax Case for further Research*, p.4

A common sub-set of international tax principles emerges on comparison of the tax policies announced by various countries and agencies. These principles are: neutrality, fairness, efficiency, certainty, avoidance of double taxation, simplicity of compliance and international consensus. Most countries have adopted the strategy of wait and watch. They want to see how Electronic Commerce evolves and what are its full ramifications, before coming forward to tax it. Most countries have also taken the stand that the existing tax laws should be adapted and applied to Electronic Commerce to the extent possible. Changes should be considered only under inevitable circumstances.¹⁸⁷

The CFA is one of the committees of OECD which is responsible for economic affairs. The Committee on Fiscal Affairs' current Programme of Work to address the taxation aspects of electronic commerce is firmly based on the Taxation Framework Conditions which were welcomed by Governments and business at the October 1998 OECD Ministerial Conference "A Borderless World – Realising the potential of Electronic Commerce". It is worth recalling the salient conclusions in that Report: - The same principles that governments apply to taxation of conventional commerce should equally apply to e-commerce.¹⁸⁸ The Taxation Framework Conditions - agreed in Ottawa in 1998 - provide the principles which should guide governments in their approach to e-commerce. It states that e-commerce should be treated in a similar way to traditional commerce and emphasises the need to avoid any discriminatory treatment. This Framework was welcomed by Member countries, non-member economies, and the business community.¹⁸⁹

The Committee on Fiscal Affairs believes that these principles can be applied through existing tax rules, and therefore any new or revised administrative measures in the framework of those rules should be directed toward the application of existing taxation principles. The CFA also believes that at this stage of development in the technological and commercial environment, existing taxation rules can implement these principles¹⁹⁰, although new or modified measures are not precluded provided that they are intended to assist in the application of the existing taxation principles, and are not intended to impose a discriminatory tax treatment of electronic commerce transactions.

¹⁸⁷ Confederation of Indian Industry, International Conference on electronic Commerce, *Tax Reforms to Promote e-Commerce in India*, p.21, giic.org/pubs/indiaTaxpaper.pdf

¹⁸⁸ OECD, *Implementing the Ottawa Taxation Framework Conditions*, oecd.org/M0001500/M013739.pdf

¹⁸⁹ *ibid*

¹⁹⁰ OECD, *Taxation Framework Conditions*, oecd.org/M0001500/M00015517

In this context, it is also important to avoid an unfair distortion of competition which would result from a de facto double or non-taxation of electronic commerce vis-à-vis fully taxed 'traditional' commerce carried out via conventional 'physical' means.¹⁹¹ The CFA was subsequently mandated to develop taxation framework conditions applicable to electronic commerce.

The CFA believes that a principles-based approach will be required in developing the taxation framework conditions and has reaffirmed that the widely accepted general tax principles should apply to the taxation of electronic commerce.¹⁹²

The U.S. Department of Treasury has published a report titled "Selected Tax Policy Implications of Global Electronic Commerce" as far back as in November 1996. The US treasury has not considered any type of value-added tax (VAT), 'bit tax' or other new excise tax on Electronic Commerce.¹⁹³ In order to ensure that these new technologies not be impeded, the development of substantive tax policy and administration in this area should be guided by the principle of neutrality. Neutrality rejects the imposition of new or additional taxes on electronic transactions and instead simply requires that the tax system treat similar income equally, regardless of whether it is earned through electronic means or through existing channels of commerce.¹⁹⁴

According to United Kingdom's governmental tax agenda this report, current taxes are sufficiently robust to mean that at this stage, it is not necessary to make any major changes to existing tax rules.¹⁹⁵

According to the report "E-commerce and Canada's Tax Administration", submitted to the Minister of National Revenue Commerce and released in April 1998, a bit tax must be rejected on the ground that such tax will be an impediment to the growth of E-Commerce. It was also stated in the report "existing tax legislation is capable of encompassing E-Commerce."¹⁹⁶

About VAT, the common tax regime of EU, it was stated in UK Tax Agenda as: "Being comprehensive in its nature, VAT is sufficiently robust to capture the vast

¹⁹¹ OECD, *A Discussion Paper on Taxation Issues*, p.4, oecd.org/pdf/M00015529

¹⁹² *ibid* p.4 also see OECD, *Consumption Tax Aspects of E-Commerce*, p.2, oecd.org/pdf/M0022378

¹⁹³ US Treasury, *Selected Tax Policy Implications of E-Commerce*, caltax.org/treas-ec.html#1

¹⁹⁴ *ibid*

¹⁹⁵ UK 's Taxagenda

¹⁹⁶ Confederation of Indian Industry, *International Conference on electronic Commerce, Tax Reforms to Promote e-Commerce in India*, p.21

majority of e-commerce transactions in its existing form. However, some adaptations to the VAT rules are needed.”¹⁹⁷

Finance ministers of ECOFIN agreed on the underlying principles and that these should form the basis of a consistent Community input to the OECD conference in Ottawa. These guidelines continue to form the basis of the Commission’s work on taxation of e-commerce. The key points provide that. **a)** No new or additional taxes need to be considered at this stage and that, **b)** In the field of indirect taxes, all efforts should be concentrated on adapting existing taxes –specifically VAT – to cope with the developments of e-commerce.¹⁹⁸

The EU Committee believes that a new tax regime to deal with electronic business is totally unwarranted. Techniques for applying existing tax principles to the electronic medium must be built upon concepts that businesses already use or are required to develop to meet market needs.¹⁹⁹

The dominant tendency within the EU can be summarised by Fritz Bolkestein’s words: “I would now like to say a word or two on why we prefer to adapt the existing tax framework to the new environment. Through the OECD, we have committed ourselves to the principle that no new or special taxes should be considered for e-commerce. We believe that this is the correct approach, but it must also be understood to carry the message that existing taxes can, and must, be made to work. This notion is central to what the Commission is now doing. The only alternative would be to look at other taxes and we do not believe that this is either realistic or desirable.”²⁰⁰

Recent technological developments may appear to be radical innovations primarily because they have evolved within a relatively short period of time. However, careful examination may very well reveal that few, if any, of these emerging issues will be so intractable that their resolution will not be found using existing principles, appropriately adjusted.²⁰¹

A major substantive issue raised by new technologies is identifying the country or countries which have the jurisdiction to tax such income. It is necessary to clarify how existing concepts apply to persons engaged in electronic commerce. In addition, transactions in cyberspace will likely accelerate the current trend to de-

¹⁹⁷ UK’s Taxagenda p.57

¹⁹⁸ EU Commission, Working Paper on Indirect Taxes and E-Commerce, p.2

¹⁹⁹ EU Committee *Position Paper on Taxation of E-Commerce*, Feb,1 200

²⁰⁰ Bolkestein F. ‘VAT on E-Commerce’

²⁰¹ CTO, Selected Tax Policy Implications of E-Commerce

emphasize traditional concepts of source-based taxation, increasing the importance of residence based taxation.²⁰²

Another major category of issues involve the classification of income arising from transactions in digitized information, such as computer programs, books, music, or images. The distinction between royalty, sale of goods, and services income must be refined in light of the ease of transmitting and reproducing digitized information.²⁰³

Generally, options to patch up the existing system are—due to continuing technological shifts—likely to result in only a temporary resolution of the issue.²⁰⁴ Existing taxation principles should not be changed in the short run. They may be adapted to facilitate application to Electronic Commerce as it evolves.²⁰⁵

Ch.2. Transactions in E-Commerce Which May Be Subject to Taxation

Electronic Commerce as a general concept covers any form of business transaction that is conducted electronically, using telecommunications networks.²⁰⁶ Electronic Commerce encompasses a broad range of activities. It covers electronic trading of physical goods and services *and* of electronic material. The whole of the commercial transaction, including ordering, transport and delivery, the invoicing and payment cycle can be supported electronically.²⁰⁷

What types of taxable economic activities will develop through the use of Internet arouses as the main question addressing in this section.²⁰⁸

Among the goods and services that are promoted and sold via Electronic Commerce are computer software and computer hardware, video cable television, music albums, photographs, books, gifts, flowers, newspapers and magazines, gambling, information data bases, education and job training, home banking, travel services, health care services, electronic bill payment, customer service, on-line stock trading, bulletin boards and chat rooms, videoconferencing and e-mail, as the most widely utilised form of Electronic Commerce.²⁰⁹

²⁰² *ibid*

²⁰³ *ibid*

²⁰⁴ California Tax Office, *California Tax Issues on Internet*, p.21, int.tax.caltax.org/ecommerce.htm 013100. Internettax.htm

²⁰⁵ Confederation of Indian Industry, International Conference on electronic Commerce, *Tax Reforms to Promote e-Commerce in India*, p.6

²⁰⁶ EU Commission, *Electronic Commerce: An Introduction*

²⁰⁷ *ibid*

²⁰⁸ OECD, *E-Commerce: The Challenge to Tax Authorities and Taxpayers*, 17Nov.1997, at Turku Finland

²⁰⁹ INES Langeder, p.21

Types of commercial activities by electronic means which may be subject to taxation can be broadly categorised into three main sections: *The use of electronic means to sell tangible products, the sale of digitised content, and internet access and telecommunications* respectively. The first two types are known as selling of goods and services by using electronic means, whereas the third is the provision of access to the internet. In many cases firms are active in both ways; they are content providers and access providers at the same time and often sell them in bundles to their subscribers.²¹⁰

A distinction should be made between electronic trading of physical goods and services and electronic trading of information-based contents that can be delivered directly through the network (images, voice, text, software...)²¹¹ The electronic trading of physical goods and services represents an evolution of present ways of trading, capitalising on new possibilities offered. This form of electronic commerce is expected to have a great impact on competitiveness and a limited impact on employment. The trading of electronic material (software, video, music, images, multimedia works, games, etc.) represents a revolutionary new way of trading, for which the full commercial transaction cycle can be conducted simultaneously via the same network including delivery. This highly innovative form of electronic commerce is expected to have an important impact on competitiveness and create employment.²¹²

To tax an economic activity, the tax authority must be able to identify a taxable event. In the case of income taxes, this requires identifying and measuring the income generated by an activity; consumption taxes rely upon identifying a transaction; taxes on capital require identifying the ownership or transfer of ownership of an asset. It is therefore necessary to identify the types of economic activities that are carried out on the Internet, where they are carried out, and by whom.²¹³

1-Advertising and sale of tangible products (Electronic mail-order)

Electronic media is increasingly used to market and sell tangible products. We can distinguish between very traditional transactions such as telephone solicitation and mail order sellers, televised 'infomercials' (long commercial messages thinly disguised as information) and finally online marketing and selling via the internet. In all cases the items purchased are tangible personal property; they must be shipped to customer by

²¹⁰ INES Langeder, p.21

²¹¹ EU Commission, *Electronic Commerce: An Introduction*

²¹² *ibid*

traditional means (postal service or common carriers) to identifiable addresses. This eases tracing and detection for tax purposes.²¹⁴

a) *Advertising*: Advertisers pay to have their advertisements disseminated to users of a given web site. While advertising is currently split between television, radio, newspapers, magazines and direct mail, the internet is likely to garner a small but rapidly growing share over the next decade.²¹⁵ So-called "banner ads" are small graphic images embedded in a web page, which when clicked by the user will load the web page specified by the advertiser.²¹⁶

b) *TV shopping/ telemarketing*: This includes all kinds of direct marketing activities conducted via electronic medium except the internet which is considered below. The sellers provide the customers with a limited amount of information. Customers place their orders either by mail or by telephone; payment is commonly made by credit cards, also by check or cash on delivery. This type of commerce generally does not raise tax issues that are substantially different from traditional trading.

c) *Electronic buying/ Web order*: Buying from Internet can be compared to leafing through an electronic catalogue.²¹⁷ The customer selects an item from an online catalogue of tangible goods and orders the item electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalogue. The product is physically delivered to the customer by a common carrier²¹⁸.

2-Sale of Services and Intangible Products ("Content")

Services and intangible products can be transmitted directly via the Internet named as direct Electronic Commerce. It is commonly referred to as provision of content and often called the 'true Electronic Commerce'. The distinguishing feature of this type of commerce is that all communication - advertising, selecting, purchasing, including payment, and especially delivery of the product - occurs (or can occur) on-line and perhaps in real time. This form of Electronic Commerce overcomes all geographic boundaries and there is no need for those providing the services or intangible goods to be close to the consumer. It is to mention that activities that may not be conducted legally in one nation.

²¹³ OECD, *E-Commerce: The Challenge to Tax Authorities and Taxpayers*, 17 Nov. 1997, at Turku Finland

²¹⁴ INES Langeder, p.21

²¹⁵ FRIEDEN K., *Cybertaxation*, p.27

²¹⁶ OECD, *Treaty Characterisation Issues Arising from E-Commerce*, p.28

²¹⁷ INES L., p.31

a-Intangible goods: Intangible goods are all products that would be considered tangible goods if not sold via Electronic Commerce but via traditional forms of commerce.²¹⁹ The customer selects an item from an online catalogue of software or other digital products and orders the product electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalogue. The digital product is downloaded onto the customer's hard disk or other non-temporary media.²²⁰ An example should make this clear: If the video is downloaded from the Internet (purchase of content) the transaction replaces another transaction in traditional commerce, namely going to a video store and buying a video cassette (purchase of a tangible good).

One of the major product categories with the most significant potential for digital deliver is computer software. The sale of canned software is expected to increase about 222 billion dollars 2003.²²¹ Computer software, movies, video games, music, books, newspapers, magazines and many other kinds of tangible products can be intangible goods. The provider of software or other digital product also may agree to provide the customer with updates and add-ons to the digital product.²²²

b) Limited duration software and other digital information licenses: The customer receives the right to use software or other digital products for a period of time that is less than the useful life of the product.

c) Data retrieval: The provider makes a repository of information available for customers to search and retrieve. The principal value to customers is the ability to search and extract a specific item of data from amongst a vast collection of widely available data.

d) Professional Services: Professional services are all services that generate income from liberal services. A consultant, lawyer, doctor or other professional service provider advises customers through e-mail, video conferencing, or other remote means of communication.²²³ Examples for professions of this group using Electronic Commerce are services of accountants, architects, management consultants, lawyers, alternative dispute resolution services and many others.²²⁴

²¹⁸ OECD, *Treaty Characterisation Issues*, p.20

²¹⁹ INES L., p.18

²²⁰ OECD, *Treaty Ch. Issues Arising from E-Commerce*, p.20

²²¹ FRIEDEN K., *Cybertaxation*, p.27

²²² OECD, *Treaty Ch. Issues* p.21

²²³ *ibid*, p.29

²²⁴ INES L., p.23

e) *Financial Services:* Financial sector Electronic Commerce has been so successful that nowadays 90 percent of the world's money transfers are made electronically. Despite that, consumers have still given their orders to transfer money in traditional ways. Changing this to electronic order –placement is a very important step in the development of banking transactions. Electronic Commerce could therefore lead to a more paperless financial sector.

f) *Information and Entertainment:* This category contains all services connected with information and entertainment and also other services that are not part of professional services like market researches and public relations, and customer service increasingly done via the Internet replacing telephone. The most important services connected to information are electronic databases. These services provide instant access to, computerised search of and downloading from, massive databases that are updated frequently. They are heavily used by businesses. Also newspapers and magazines are intensively using the Internet.²²⁵

g) *Streamed (real time) web based broadcasting:* The user accesses a content database of copyrighted audio and/or visual material. The broadcaster receives subscription or advertising revenues.

h) *Online auctions:* The provider displays many items for purchase by auction. The user purchases the items directly from the owner of the items, rather than from the enterprise operating the site. The vendor compensates the provider with a percentage of the sales price or a flat fee.²²⁶

Although because of demands of bandwidth some parts of this market are still quite limited, the technological advances will soon overcome these constraints. There is a very huge market potential of this type of electronic commerce.

3-Telecommunications and Internet Access Services:

Internet service providers offer a variety of services including email services, browser programs, and Internet access and custom websites.²²⁷ Currently, the largest economic activity within E-commerce is telecommunications services. Telecommunication services, whether provided by traditional copper wires, coaxial cable, fibre-optic cable, wireless cellular telephones or satellite, are the crucial transport

²²⁵ INES L., p.12

²²⁶ OECD, Treaty Ch. Issues, p.30

²²⁷ BASU Subhajt, Taxation of E-Commerce, JILT, elj.warwick.ac.uk/jilt/01-2/basu1.html

mechanisms that carry voice, data and video and other products to business and personal consumers.²²⁸ Telecommunication carriers are deriving income from providing basic transmission of online services. Internet users purchase telecommunications capacity from communication carriers in order to gain access to Internet and online services.²²⁹

a) *Web site hosting*: The provider offers space on its server to host web sites. The provider obtains no rights in the copyrights created by the developer of the web site content. The provider is compensated by a fee based on the passage of time.

b) *Carriage Duties*: A content provider pays a particular web site or network operator in order to have its content displayed by the web site or network operator.

c) *Application Service Provider ("ASP")*: The provider obtains a license to use a software application in the provider's business of being an application service provider. The provider makes available to the customer access to a software application hosted on computer servers owned and operated by the provider. The software automates a particular back-office business function for the customer. The provider does not provide the goods or services. It merely provides the customer with the means to automate and manage its interaction with third-party providers of these goods and services.²³⁰

d) *Internet Telephony*: Another major category is internet telephony. It entails the use of the internet and packet switching technologies to carry voice and other telephone traffic. Internet protocol will prove particularly attractive for transporting the large amount of data that currently is transported over regular telephone channels.²³¹

Making a more general and opportunist approach, the internet based electronic commerce activities can be grouped as:

a) *The Sale-Lease of Goods*: There are numerous web sites enabling buyers to select, pay and order physical goods which are then delivered by traditional mail-order methods. Some digital "goods" can already be downloaded (e.g. computer software, magazines and newspapers) and it is expected that most "goods" capable of being digitised (e.g. compact disks, videos) will be able to be delivered by downloading within the next few years.

²²⁸ FRIEDEN K., *Cybertaxation*, p.22

²²⁹ INES L., p.30

²³⁰ OECD, *Treaty Ch. Issues*, p.22

²³¹ FRIEDEN K., *Cybertaxation*, p.24

b) *The Provision of Services:* Many traditional services are available via the Internet. Web sites offer offshore banking services, ticketing arrangements, stock-brokerage services, the provision of health care advice and other professional services.

c) *The Provision of On-line Information:* Services such as Lexis and Nexis have created large computerised databases which can be accessed by customers, with the information either being read on screen or printed.

d) *Advertising:* Commercial enterprises are increasingly using the Internet to advertise their goods and services.²³² Indeed, the major web portals such as American Online, Yahoo. Lycos, Excite already have estimated audiences of 25 million or more, rivalling the audience size of the major television networks. These portals already charging premium rates for companies to advertise on valuable real estate in cyberspace.²³³

e) *Gambling:* Another category that lends itself to digitisation is gambling. In the US gambling in casinos lotteries, horse races and sports betting is an estimated 600 billion dollar industry. Online betting could reach 4.2 billion by 2003.²³⁴

Hitherto, gamblers could only bet in countries where this was legal, and on events sanctioned there – now they are able to gamble on the Internet with relative ease, even though legislation in their home countries may prohibit gambling. For example, gambling is legal over the Internet in the USA as long as the company running the gambling site is located in a state where gambling is legal.²³⁵ The Internet opens up new possibilities for 24 hour global gambling: the ultimate Las Vegas.

f) *Global Dealing:* This refers to the capacity of financial institutions and MNE's to engage in 24 hour trading, with the "book" moving between time zones.²³⁶

CH.3..GENERAL PRINCIPLES FOR TAXATION OF E-COMMERCE

²³² OECD, Turku Summit

²³³ FRIEDEN K., Cybertaxation, p.26

²³⁴ ibid p.35

²³⁵ BASU Subhajt, Taxation of E-Commerce,

²³⁶ OECD, TURKU Summit

The emerging global information society not only makes international differences in traditional economic production factors, such as wages, more transparent, it also makes clear the international differences in direct and indirect taxation and social security contributions.²³⁷ Unlike most previous market innovations, the transnational and intangible nature of Electronic Commerce has especially direct implications for the ability of governments to raise revenues through established mechanisms like sales and corporate taxes, value added taxes and tariffs.²³⁸

For over 50 years, nations have negotiated tariff reductions because they have recognised that the economies and citizens of all nations benefit from freer trade. Further, the Internet lacks the clear and fixed geographic lines of transit that historically have characterised the physical trade of goods, the structure of the Internet makes it difficult to do so when the product or service is delivered electronically.²³⁹ The mode of doing business through electronic commerce may add new layers of difficulty and may require solutions to both the problem of no taxation or double taxation and to the problem of administrative burden.²⁴⁰

The international and intangible characteristics of Electronic Commerce suggest to many that it may open up avenues that legally circumvent national tax structures altogether, as well as facilitating outright tax evasion and fraud.²⁴¹ The potential speed, untraceability and anonymity of electronic transactions may also create new possibilities for tax avoidance and evasion. These need to be addressed in order to safeguard the revenue interests of governments and to prevent market distortions.²⁴² Nevertheless, many nations are looking for new sources of revenue, and may seek to levy tariffs on global electronic commerce.²⁴³

In each of these areas there is a need for reflection, research on alternative, as well as adaptations to existing tax regimes more appropriate to the emerging global information society and in some areas policy action.²⁴⁴

At this stage, where e-commerce technology is still developing and patterns of trade are as yet unclear it is not necessary or possible to change the existing scheme of tax. However, broad guidelines are needed to steer the direction of the ongoing debate

²³⁷ HLEG, Building the Information Society for Us All, p.41

²³⁸ Sacher Report p.51

²³⁹ Whitehouse, A Framework for Global E-Commerce

²⁴⁰ GIIC, A Discussion Paper on E-Commerce Taxation Issues

²⁴¹ Sacher report p.52

²⁴² EU Commission, Greenpaper

²⁴³ Whitehouse, A Framework for Global E-Commerce

and to guide, in consultation with the business sector, future developments in the tax field in this new and rapidly growing global marketplace.²⁴⁵

This has already been recognised in the EU Commission's "Communication on Electronic Commerce", which proposed the principle of "*no regulation for regulation's sake*". This principle applies equally to all areas of convergence²⁴⁶ also for tax environment.

The GIIIC, Forum for the Global Information Infrastructure, is a private sector advocacy group bringing together 50+ CEO's and executive level leaders of major international corporations with a stake in the development of the global information infrastructure. GIIIC members are from both developed and developing countries. GIIIC defends *simplicity, clarity, and fairness* must be promoted in both national tax regimes and supranational tax regimes (e.g. the European Union's value-added tax system), as well as bilateral tax agreements for the avoidance of double taxation based on international models, in order to allow for the global trading potential of electronic commerce. Tax rules everywhere should be *understandable and user-friendly* to allow for the potential increase in cross-border sales by companies. Application of existing taxation principles to the electronic medium must also be built upon tools that businesses already use or are required to develop to meet their market needs. Tax obligations should especially *fit into the new streamlined processes* found in electronic commerce. It is only in this way that *high tax compliance can be sustained with the least burden and the fewest economic distortions*.²⁴⁷

To allow electronic commerce to develop, it is vital for tax systems to provide *legal certainty* (so that tax obligations are clear, transparent and predictable), and *tax neutrality* (so there is no extra burden on these new activities as compared to more traditional commerce). Rules should be *restricted to a minimum* and *disproportionate obligations avoided* in order to allow e-commerce to flourish. However, at the same time, there must be assurances that the *tax can be controlled in an effective way*.²⁴⁸

The US as one of the main actors in international fora about taxation issues declared some principles about the matter. Any taxation of Internet sales should follow these principles:

²⁴⁴ HLEG, Building the Information Society for Us All p.42

²⁴⁵ EU Commission, Communication on ' Indirect Taxes and E-commerce'

²⁴⁶ EU Commission, Greenpaper

²⁴⁷ GIIIC, A Discussion Paper on Taxation Issues

²⁴⁸ EU Commission, Communication on ' Indirect Taxes and E-commerce'

- It should neither distort nor hinder commerce. No tax system should discriminate among types of commerce, nor should it create incentives that will change the nature or location of transactions.
- The system should be simple and transparent. It should be capable of capturing the overwhelming majority of appropriate revenues, be easy to implement, and minimize burdensome record keeping and costs for all parties.
- The system should be able to accommodate tax systems used by the United States and its international partners today.²⁴⁹

This approach does not preclude new administrative or legislative measures, or changes to existing measures, relating to electronic commerce, provided that those measures are intended to assist in the application of the existing taxation principles, and are not intended to impose a discriminatory tax treatment of electronic commerce transactions.

In November 1997, the OECD held an international conference in Turku, it was agreed that the criteria to guide the development of the tax framework would be: Guiding criteria: neutrality, fairness, certainty, and the need to avoid excessive taxation.²⁵⁰

The Committee on Fiscal Affairs' current Programme of Work to address the taxation aspects of electronic commerce is firmly based on the Taxation Framework Conditions which were welcomed by Governments and business at the October 1998 OECD Ministerial Conference "A Borderless World – Realising the potential of Electronic Commerce". International principles for taxing e-commerce were discussed at the OECD Ministerial Conference in Ottawa in 1998.²⁵¹ The framework sets out the key taxation principles that OECD member countries have concluded should guide governments in relation to taxation of electronic commerce.²⁵²

It is worth recalling the salient conclusions in that Report: The same principles that governments apply to taxation of conventional commerce should equally apply to e-commerce, namely,²⁵³

a) Neutrality

²⁴⁹ Whitehouse, A Framework for Global E-Commerce

²⁵⁰ UK's Taxagenda, p.45

²⁵¹ Bolkestein F., *VAT on E-Commerce*

²⁵² ATO, Tax and the Internet, Second Report, December 1999, p.11

²⁵³ OECD, *Implementing the Ottawa Taxation Framework Conditions*

Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce.²⁵⁴ so that double taxation or unintentional non-taxation can be avoided.²⁵⁵

The overriding principle is that there should be broad neutrality between the treatment of businesses engaged in traditional physical commerce and those engaged in electronic commerce. Practically this means that, wherever possible and subject to the differences in the environments, business engaged in electronic commerce should be subject to equivalent arrangements as businesses engaged in physical commerce (functional equivalence).²⁵⁶ Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.

The principle of neutrality between physical and electronic commerce requires that existing principles of taxation be adapted to electronic commerce, taking into account the borderless world of cyberspace. An advantage of an approach based on existing principles, in addition to neutrality, is that such an approach is suitable for adaptation as an international standard. Existing principles are, in broad outline, common to most countries' tax laws.²⁵⁷

b) Efficiency

Efficiency in taxation means collecting maximum amount of tax by minimum taxation costs and burdens both for governments and tax payers.²⁵⁸ Thus, compliance costs and burdens for taxpayers and administrative costs for the tax authorities should be minimised as far as possible.

c) 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, including knowing when, where and how the tax is to be accounted²⁵⁹ so that taxpayers know where they stand.²⁶⁰ The credibility of any system of taxation rests on its practicality, and the feasibility of its implementation. There should be certainty about the rules and

²⁵⁴ OECD; *Taxation Framework Conditions*

²⁵⁵ OECD, *Implementing the Ottawa Taxation Framework Conditions*,

²⁵⁶ Australian Tax Office (ATO), *Tax and the Internet*, Second Report, December 1999, p.10

²⁵⁷ California Tax Office, *Selected Tax Policy Implications of E-Commerce*

²⁵⁸ TURK İsmail, *Kamu Maliyesi*, Turhan Yay. Ankara 1999, 3.Ed., s.107,

²⁵⁹ OECD, *Taxation Framework Conditions*,

²⁶⁰ OECD, *Clarification of the Permanent Establishment Definition in E-commerce*, oecd.org/pdf/M00013735

compliance should be made as simple as possible to avoid unnecessary burdens on business.²⁶¹

d) Effectiveness and Fairness

Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counter-acting measures proportionate to the risks involved.

e) Flexibility

The systems for the taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.²⁶² Any global approach or framework needs to be flexible enough to support the growth of the information economy, encourage trade and investment flows, create jobs, and provide consumers with the benefits of competition, while encouraging a stable, secure environment for electronic transactions.²⁶³

The Committee on Fiscal Affairs believes that these principles can be applied through existing tax rules, the process of implementing these principles should involve an intensified dialogue with business, with non-business taxpayer groups, and with non-OECD member economies. Since Ottawa, the Framework Conditions have gained wide acceptance internationally and are widely accepted as a sound basis for developing a consensus on the treatment of taxation issues raised by e-commerce.²⁶⁴

EU Commission also laid down broad guidelines for electronic Commerce in its Communication 1997(157). These are:

Guideline 1: No new taxes: The first guideline has been formulated to reflect the basic concept that existing taxes should apply to electronic commerce:

Guideline 2: Electronic transmissions as services: A supply that results in a product being placed at the disposal of the recipient in digital form via an electronic network is to be treated for VAT purposes, as a supply of services.

Guideline 3: Ensuring neutrality,

Guideline 4: Making compliance easy: Compliance for all operators in the field of e-commerce should be made as easy and simple as possible.

²⁶¹ EU Commission, *Communication on Indirect Taxes and E-Commerce*

²⁶² OECD, *Taxation Framework Conditions*

²⁶³ GIIIC, *Dialog Beyond G-8*

²⁶⁴ OECD, *Clarification of the Permanent Establishment Definition in E-commerce*,

Guideline 5: Ensuring Control and enforcement: There must be assurances that the tax can be controlled in an effective way.

Guideline 6: Facilitating tax administration.

As seen clearly, the guidelines laid down by OECD, EU and business environment representatives are to great extent, point out the same issues. Application of existing rules by slight alteration-where necessary – would be more practical rather than enforcing new principles for taxation of e-commerce.

CH 4 .. DIFFICULTIES OF TAXATION REGARDING TO E-COMMERCE

The problem with taxing communication services and electronic commerce lies within the fact that the taxation rules were developed long years ago,²⁶⁵ at least before development of telecommunications and invention of the Internet. Strictly speaking, there are as yet no specific international or national legal frameworks for taxing e-commerce.²⁶⁶ The deep concern exhibited by both government and industry over the impact of e-commerce on local, state, federal and international taxation, is attributable to trends occurring within the internet economy. The rise in borderless commerce, the emergence of digital commerce, the explosion of real time transactions, and the revolution of new business models all exert pressure on traditional tax systems that were designed for a different era. Most taxing jurisdictions continue to use a mid-20th Century tax system –designed largely for manufacturers and vendors of tangible personal property- to tax a technologically advanced 21st Century service industry. Not surprisingly, these old tax rules are often ill-suited to taxing e-commerce.²⁶⁷

The incompatibility of old tax rules and “new economy” commerce is evident in the growing tension and friction within the tax world over the application of tax rules to leading e-commerce businesses. The complexity of adapting tax rules to e-commerce is manifest across tax types, income, gross receipts, and property taxes.²⁶⁸

One possible positive vision is that the New Economy will be one where few people work in traditional ways.²⁶⁹ So the traditional ways of taxation may be inadequate, governments have not yet realised where and how wealth creation is taking

²⁶⁵ *Taxing Cyberspace: The Argument*

²⁶⁶ ITC, *Secrets of E-Commerce*, p.79

²⁶⁷ FRIEDEN K., *Cybertaxation*, p.60

²⁶⁸ *ibid* p.61

place and not yet figured out a way to tax and redistribute some of the new wealth created by global digital networks.²⁷⁰

The policies and rules governing the taxation of electronic commerce cannot be developed without an understanding of the underlying technical features.²⁷¹ Although chapter two above presented a sampling of current means of electronic commerce transactions, the basic technical structure of the Internet has some important implications for tax policy and administration.

a) *The lack of 'traceability':*

One of the main problems is tracing "intangible goods" sold via the Internet, such as an electronic newspaper or a software programme. Developments in electronic payment systems also pose issues for tax administration. Electronic payment systems may partially displace cash, cheques and credit cards, which currently constitute about 90 percent, by volume, of financial transactions. Electronic payment systems have the potential to create new forms of money in which value is represented in digital form.²⁷² The development of electronic cash as opposed to credit card systems will probably further facilitate both electronic commerce and tax evasion since payment no longer leaves a paper but is rather anonymous and untraceable.²⁷³

The Internet may also reduce the role of the intermediaries - important to tax authorities as they report financial transactions. Furthermore, it will be increasingly easy for the average citizen to access offshore financial centres in cyberspace. These virtual tax havens are likely to further paralyse the tax collector.²⁷⁴

Through modelling, scenario planning and actual audits of businesses engaged in electronic commerce, there are a number of challenges for tax administrations. These include:

- difficulties in identifying the parties behind Internet businesses;
- the ability of these businesses to store tax records offshore, or to encrypt them or to alter them without trace;
- the possibility that some types of electronic money could exacerbate the problems of the physical cash economy;

²⁶⁹ Arthur Cordell, *New Taxes for A New Economy*

²⁷⁰ *ibid*

²⁷¹ CTO, Selected Tax Policy Implications of E-Commerce

²⁷² OECD, TURKU Summit

²⁷³ *Taxing Cyberspace The Argument*

²⁷⁴ *ibid*

- the removal of efficient tax collection points such as 'middlemen' in the distribution chain from producer to consumer, in an effect known as 'disintermediation';
- and the ability of the technologies to change the nature of products, through 'digitisation' and hence the taxation treatment of the income from the sale of those products.

Most of these challenges are proposed to be addressed by adapting the existing taxation rules to the new environment, mirroring the migration of some businesses from physical commerce to electronic commerce.²⁷⁵

b) Changing Business Models:

The Internet is also fuelling a revolution in business models that is creating new and challenging issues for tax systems. There are range of evolving business models such as online auctions, virtual communities, infomediaries, aggregators, and brokers. These new business models are significantly altering the landscape of interactions between suppliers, sellers and buyers creating many new tax issues.²⁷⁶

c) Lack of any user control as to the location of activity

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. Many participants in the system are administrators or go-betweens who have no control over what type of information travels over their computer. In practice, it makes no difference whether the data or digital tokens sought to be transmitted are within one jurisdiction or between several, as the Internet pays little or no regard to national boundaries. As the physical location of an activity, whether in terms of the supplier, service provider or buyer of the goods or user of the service becomes less important, it becomes more difficult to determine where an activity is carried out

d) No means of identification of users

In general, proof of identity requirements for Internet use are very weak. The pieces of an Internet address (or "domain-name") only indicate who is responsible for maintaining that name. It has no relationship to the computer or user corresponding to that address or even where the machine is located. In addition, it is not difficult to introduce a new computer to the Internet which has the ability to be recognised

²⁷⁵ Australian Tax Office (ATO), *Discussion Report of the ATO Electronic Commerce Project*

²⁷⁶ FIEDEN K., *Cybertaxation*, p.50

anywhere else on the Internet. Registration requirements are not difficult to satisfy and there is little to prevent transfer of the site to new controllers.²⁷⁷

Taxpayers can establish and operate from an internet address in any jurisdiction, even though they effectively reside elsewhere.²⁷⁸

e) Reduced use of information reporting and withholding institutions.

In general, tax compliance is facilitated by identifying key "taxing points"; for example, reporting and withholding requirements can be imposed on financial institutions which are easy to identify. In contrast, one of the great commercial advantages of electronic commerce is that it often eliminates the need for intermediating institutions.²⁷⁹

Taxation authorities rely on wholesalers and retailers as collectors of various forms of taxes. Because of their small numbers, these tax collection points are much more controllable. E-commerce, however, threatens this entire model of tax collection. E-commerce enables manufacturers to sell directly through their websites to consumers without intermediaries ("disintermediation"). Because thousands and tens of thousands of consumers may purchase from these manufacturers, it is difficult for tax authorities to audit individual consumers. In fact, many tax jurisdictions could lose the chance of collecting any taxes if the manufacturer is located in a different tax jurisdiction.²⁸⁰

The growth in internet commerce will make obtaining information necessary for enforcement difficult, particularly when transactions involve jurisdictions with which no tax treaty exists.²⁸¹

f) Accessibility of offshore banking :

The increasing ease of shifting funds offshore to tax havens, secrecy laws in tax havens providing anonymity, and low transaction costs will make countering international tax evasion difficult.²⁸²

g) The Hollow Corporation:

The Internet is also accelerating the trend towards hollow corporations with narrowly defined core competencies. Companies are more likely to define their core competencies and leave manufacturing, distribution, fulfilment, customer services and other functions to third parties. Internet businesses will frequently have more flexibility to

²⁷⁷ OECD, Turku Summit

²⁷⁸ New Zealand Tax Office, E-Commerce and Taxation Report, ind.gov.nz/library/ecommerce.htm

²⁷⁹ OECD, TURKU Summit

²⁸⁰ EPP Todd, An Internet Tax Primer, The Institute of Internal Auditors,

²⁸¹ New Zealand's Tax Office, E-commerce Report

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, had quarter employees of information technology personnel than it is to move around large factories.²⁸³

h) Detection of contents:

Since all electronic communication consists of streams of binary digits, it is difficult, if not impossible; to determine the contents until converted. At present, a personal letter appears indistinguishable from a message transmitting electronic money.

Some commentators may argue that few of these characteristics are new and that many of the problems they pose for tax administrations are similar to those posed by mail-order businesses or by developments in the communication sector in the 1970s. But few would dispute that the speed, global access and automation of functions provided by communications on the Internet, the mobility it offers, and the potential for new payment systems, may change the way business is being undertaken. The use of electronic media creates a qualitative difference in the way existing activities can be carried out and taxed. But at the same time these techniques will open up new ways in which tax administrations can assess and collect taxes.²⁸⁴

CH.5.. NEED OF CO-OPERATION

Electronic commerce is an emerging and fast-developing form of trade which does not respect borders; so poses also some challenges stated above. It clearly requires co-ordinated responses on the part of public administrations. The only way to meet these challenges is by more effective co-operation between countries.²⁸⁵ An international perspective is necessary to address this subject since e-commerce potentially crosses national borders to a greater extent than other, traditional forms of doing business. Therefore, it is important for every nation to give serious consideration to the impact on its trading partners of any new or amended rules for taxation of e-commerce. In order to minimise the potential for double taxation, an international consensus for the taxation of e-commerce should be developed.²⁸⁶

²⁸² New Zealand's Tax Office, E-commerce Report

²⁸³ FRIEDEN K., *Cybertaxation*, p.49

²⁸⁴ OECD, *E-Commerce: The Challenge to Tax Authorities and Taxpayers*, 17 Nov.1997, at Turku Finland oecd.org/daf/fa/turku18.pdf

²⁸⁵ ABEELE Michel, *Taxes without Borders*, World Tax Conference, Tampa USA,27 Feb. 2000

²⁸⁶ ACEC Report, p.3

The international nature of e-commerce brings with it the need to find global solutions to the taxation issues that it raises. If international trading is to be encouraged, business needs certainty and clarity over how international tax rules will work. At the same time, governments need to ensure that the rules work in a way that does not lead to a loss of tax revenue. Working with other governments and business to achieve these aims is essential. If countries take different approaches or act unilaterally, there could be double taxation or unintentional non-taxation; excessive compliance burdens for business; and opportunities for the dishonest to evade or avoid taxes.²⁸⁷

Unlike more traditional taxation fields, the tax environment for e-commerce has a global perspective which needs ultimately to be addressed at such a level. In the longer run, the development of a tax system which is compatible with the interests of e-commerce will require enhanced international co-operation between tax administrations.²⁸⁸

The global networked economy needs increasingly flexible legislative solutions to the challenges posed by rapid technological change. These solutions must be formulated on the basis of international dialogue among various stakeholders in the information revolution, including the private sector, national governments, international organisations and consumer groups.²⁸⁹

Industry and government should maintain a dynamic international dialogue on the harmonisation of Electronic Commerce and Electronic Administration principles.²⁹⁰ These play a vital part in working towards the governments' goal. But e-commerce is a truly global phenomenon, and international debate and co-operation have been crucial to the progress which has been made on finding global solutions to the taxation issues thrown up by e-commerce. Governments must recognise that international consensus is needed to give business certainty and avoid double taxation and unintentional non-taxation.²⁹¹

The Internet could give rise to spill-over between issues dealt with by different organisations and currently involves important new and less conventional actors, such

²⁸⁷ UK's Taxagenda, p.27

²⁸⁸ Bolkestein F, *Is Europe ready for the new economy?* 27 March 2000,

²⁸⁹ GIIC, Dialog Beyond G-8

²⁹⁰ Sacher Report, p.15

²⁹¹ UK's Taxagenda p.7

as the Internet Society. Furthermore, any formal principles and rules will most likely need to draw on some element of self-regulation by industry players.²⁹²

In order to clarify the need of cooperation and coordination also to see the roles of main actors in the area, the following chapters would be helpful:

5.a.. International Co-ordination and Co-operation

The ease with which business can now be fragmented and relocated starts to set off alarm bells for most revenue authorities. The benefit of such flexibility is viewed by most as conferring economic benefits on business. Tax authorities see it differently. It potentially opens the gate to tax avoidance opportunities – relocating operations and profits to tax havens. Most developed countries have worked hard over the last two decades to stamp out such avoidance. Revenue authorities are therefore not pleased at the prospect of e-commerce creating a second round of such avoidance activities. It is these issues and challenges which have driven the unrelenting interest of governments worldwide to address these matters and, where necessary, find solutions.²⁹³

The Internet and its associated “e-commerce” activities have been evolving at a rapid pace, raising many important issues for policymakers at all levels of government.²⁹⁴ The challenges posed to tax systems by Internet Electronic Commerce are real and governments will need to focus on how to address them in a spirit of collective co-operation. The allocation of taxing rights must be based upon mutually agreed principles and a common understanding of how these principles should be applied. Even if such a consensus is achieved, governments may find that their ability to enforce taxation may be diminished. Without such a consensus, the Internet and other new communication technologies may pose a serious challenge to governments in maintaining their revenue bases.²⁹⁵

Recognising the special characteristics of the commercial environment provided by the Internet, an internationally agreed legal definition is urgently required as to where commercial transactions on the Internet are deemed to have taken place. An internationally clarified legal environment must be supported by international agreement on policing and enforcement.²⁹⁶

²⁹² EU Commission, Green Paper

²⁹³ TOBIN Gilbert, E-Commerce: A Taxing issue, qtlaw.com.au/t/publication/default.jsp?pubid=259

²⁹⁴ California Tax Office(CTO), California Tax Issues on Internet, p.1

²⁹⁵ OECD, Turku Summit

²⁹⁶ Sacher report, p.17

Electronic commerce is inherently a global activity. Improved access to global markets is accompanied by the challenge from other parts of the world. Multilateral dialogue, involving governments and industry, is currently being pursued in many forums.²⁹⁷

Tax regimes have to co-operate in order to avoid conflicts among jurisdictions and the risk of multiple taxation, as unilateral actions can lead to distortions of trade and prohibit the development of electronic commerce. These facts make international consensus absolutely essential. Agreeing to that, the US Treasury states that 'if these technologies are to achieve their maximum potential common rules that provide certainty and prevent double taxation are required.'

Indeed, many of the questions raised by e-commerce taxation generally particularly those relating to administration of taxes are global issues and international consensus in this area is extremely important.²⁹⁸ In order to respond fully to the global reach of electronic commerce, revenue authorities will need to work co-operatively.²⁹⁹

International co-operation can also contribute to the ways in which governments can use developments in technology to improve the service it offers. Sharing experiences and expertise will help ensure to put in place the best systems and products.³⁰⁰

Co-operation must go beyond bilateral treaties and extend to achieve an international consensus. Achieving international consensus must be given higher importance than the exact balance between residence and source based taxation.³⁰¹

Before any further action is taken, states and local governments should co-operate to develop a uniform, simple approach to the taxation of electronic commerce, based on existing principles of taxation where feasible.³⁰² Such co-operation will be particularly needed to ensure that electronic commerce does not lead to harmful tax competition and that taxation does not present a barrier to growth.³⁰³

International debate and co-operation have been crucial to the progress. Most governments believe that the OECD, and for VAT the European Union, are the most

²⁹⁷ EU Commission, *A European Initiative in E-Commerce*, Com97(157) p.5,

²⁹⁸ Bolkestein Frits, *A Changing Approach to Taxation with the Development of E-Commerce*, 14 Sept 2000

²⁹⁹ OECD, *A Discussion Paper on Taxation Issues*, p.29

³⁰⁰ UK Taxagenda, p.27

³⁰¹ INES Langeder p.27

³⁰² Whitehouse, *A Framework for Global E-Commerce*

³⁰³ Bolkestein Frits, *A Changing Approach to Taxation with the Development of E-Commerce* 14 Sept 2000

appropriate fora for this ³⁰⁴ and states are eager to participate in workshops held by these parental institutions so as to contribute to the development of the issue.

5.b..Role of International Organisations

Existing international organisations, such as the World Intellectual Property Organisation (WIPO), the ITU and the OECD have perceived the need to consider the potential impact of convergence and to launch Internet and electronic commerce related activities. In some cases, this has already led to agreement on principles or minimal rules. Examples include the two WIPO Treaties of December 1996 on copyright and certain related rights (the "WIPO Copyright Treaty" and "the WIPO Performance and Phonograms Treaty"), and the Bonn Declaration of July 1997.³⁰⁵

Regulation on the Internet is an issue that goes well beyond taxation. Internationally agreed solutions will need to be found not just for taxation, but for enforcement of laws on copyright, intellectual property rights and public policy interests generally.³⁰⁶

The following is a brief outline of the major international organisations which are active in developing public policies impacting the business of electronic commerce.

The European Union is by far the most active of all international organisations in developing directives and policies impacting the information economy. Their directives shape the economic climate and actions of the industrialised nations of Europe. The professional staff of the Commission, based in Brussels has been very aggressive in identifying and acting on policy issues for the Information Society.

THE EU-US JOINT STATEMENT ON E-COMMERCE:

At their December 1997 summit, the EU and the United States of America issued a joint declaration on e-commerce. They agreed to "work towards the development of a global market place where competition and consumer choice drive economic activity, on the basis of [a number of] guidelines, including, that taxes on electronic commerce should be clear, consistent, neutral and non discriminatory". To achieve the goals it was agreed to continue discussions in appropriate multilateral fora, including the OECD.

³⁰⁴ UK's Taxagenda, p.32

³⁰⁵ EU Commission, Green Paper

³⁰⁶ Bolkestein Frits, A Changing Approach to Taxation with the Development of E-Commerce 14 Sept 2000

At the following summit in May 1998, there was agreement to the development of an internationally agreed framework for e-commerce.³⁰⁷ Efforts of European Union will be examined deeply in below coming sections.

2. The Organization for Economic Co-operation and Development (OECD) grew out of the post World War II Organisation for European Economic Co-Operation (OEEC) which was charged with administration of the United States Marshall Plan. The OECD has no international legal powers and no financial resources for loans and subsidies. Its function is to direct co-operation among member states. It offers a forum for collaborative approaches to issues of the globalisation of the world economy. The OECD serves as a global policy development centre to build consensus among national governments on current issues. It has been studying issues associated with the "information society" for nearly two decades.³⁰⁸

The OECD has been taking forward the tax issues raised by e-commerce.³⁰⁹ It has just launched a major policy development effort to address the myriad of issues under the umbrella of electronic commerce. This would include electronic payments systems and banking issues, security, privacy, encryption, and legal harmonisation.

The Organisation for Economic Co-operation and Development ("OECD") is the appropriate forum to sponsor the required international dialogue, which will require input from the business community and non-OECD countries.³¹⁰

The OECD has taken a leadership role in reviewing existing taxation frameworks relating to e-commerce, with important progress now being made on issues ranging from consumption taxes to tax treaties and the tax treatment of digitised goods such as software.³¹¹

Enormous amount of research has been done within the OECD and IFA on the issues relating to taxation of e commerce. The reports produced by IFA and OECD helped the Committee understand the issues involved.³¹²

TURKU CONFERENCE

In November 1997, the OECD held an international conference in Turku, Finland at which government and business representatives from around the world met to review

³⁰⁷ UK Taxagenda p.30, for further info, see www.ispo.cec.be

³⁰⁸ OECD, *The Economic and Social Impact of Electronic Commerce*, OECD Publications, Paris 1999, for further info, see www.oecd.org

³⁰⁹ UK's Taxagenda, p.27

³¹⁰ ACEC Report, p.3

³¹¹ SING Kanwarjit, *Taxation of Electronic Commerce*, leaveit.2kj.com

³¹² SING Kanwarjit, *Taxation of Electronic Commerce*, leaveit.2kj.com

and debate OECD work on the impact of e-commerce on business. The OECD was mandated to prepare a framework for the taxation of e-commerce and an undertaking was given to engage the business sector in a series of working dialogues on the issues.

It was agreed that the criteria to guide the development of the tax framework would be *neutrality, fairness; certainty, and the need to avoid excessive taxation*.

OECD member countries held a series of meetings with business in the course of drawing up the framework. These were essential in reaching broad understanding of the issues and opportunities.

OTTAWA CONFERENCE

The framework was presented to Ministers at a conference held by the OECD in Ottawa in October 1998. Tax was one of four topics addressed, the others being consumer protection, authentication and privacy. Business representatives, governments from OECD member countries and a number of non-OECD member countries attended. A number of broad principles applying to the taxation of e-commerce were agreed.³¹³ Ottawa was a very important milestone for developing international consensus on principles of e-commerce taxation.

Committee of Fiscal affairs (CFA) is the main body of OECD which is responsible from e-commerce taxation issues. Five Technical Advisory Groups (TAGs) within CFA have been established, which include participants from member countries, non-OECD member countries and businesses from a wide range of sectors and jurisdictions. Their role is to advise the member country working parties on the specific issues within the work programme. This is a unique development in the work of the OECD and reflects the importance placed by the member countries in achieving international solutions in partnership with business.³¹⁴

3. Group of Seven Nations (G7) operates as a powerful, though informal gathering of the leaders of the seven major economic powers (United States, United Kingdom, France, Germany, Italy, Canada and Japan). Among its major activities is the ongoing policy working group on electronic commerce.

4. Asia-Pacific Economic Cooperation (APEC) was formed in 1989 in response to the growing interdependence among Asia-Pacific economies. In 1994 APEC's 18 member economies had a combined gross national product of over \$13 trillion, about half the world's total annual output. Together, they represent 46 percent of the world's total

³¹³ UK's Taxagenda p.28

³¹⁴ *ibid* p.29

merchandise trade. APEC is committed to promote electronic commerce through seminars, studies and experiments.

5. The World Trade Organization (WTO) has become notable to the IT industries. The WTO is based in Geneva, and has a staff of about 450. It was founded in 1995 as the culmination of 49 years of international negotiations on trade-liberalisation. Therefore, the United States will advocate in the World Trade Organisation (WTO) and other appropriate international fora that the Internet be declared a tariff-free environment whenever it is used to deliver products or services.³¹⁵

The WTO is a forum for governments rather than SMEs, its activities may not be of direct help to e-commerce companies in developing countries although its proceedings may be of interest.³¹⁶

The Second Ministerial conference of the World Trade Organisation (WTO) in May 1998 agreed on a declaration establishing a comprehensive work programme "*WTO DECLARATION ON GLOBAL E-COMMERCE*" for all trade-related issues of e-commerce. It was also decided that all WTO members would continue the current practice of not imposing customs duties on electronic transmissions.³¹⁷

7. The World Intellectual Property Organisation (WIPO), a UN specialised agency promotes the protection of IP throughout the world through the administration of two treaties: the Paris Convention for the Protection of Industrial Property of 1883, and the Berne Convention for the Protection of Literary and Artistic Works of 1886.

The WIPO General Assembly requested its International Bureau to conduct a study on the international intellectual property issues arising from the new global information infrastructure, including the Internet. An initial focus of this study is the relationship between trademarks and Internet domain names. WIPO implements a "Cooperation for Development Programme". It assists preparations for the implementation of agreements on trade related aspects of intellectual property rights, technology transfer, the use of the internet and e-commerce.³¹⁸

9. The United Nations Conference on Trade and Development (UNCTAD), moved quickly into the information age with its UN International Symposium on Trade Efficiency (UNISTE) held in Columbus, Ohio in 1994. This conference brought together government and private sector from around the world to explore the uses of new

³¹⁵ Whitehouse, A Framework for Global E-Commerce

³¹⁶ ITC, *Secrets of E-commerce*, p.228, for further info: see www.wto.org

³¹⁷ UK's Taxagenda p.31

³¹⁸ ITC, *Secrets of E-Commerce*, p.228, for further info, see www.wipo.org

information technology in expanding world trade. It also makes awareness creation in e-commerce activities through conferences and meetings. The large majority of them are non profit associations involving both public and private sector participants.³¹⁹

10)The United Nations Conference on International Trade Law (UNCITRAL) this past year adopted the 'Model Law on Electronic Commerce' which is intended to facilitate the use of modern means of communications and storage of information, such as electronic data interchange (EDI), electronic mail and telecopy, with or without the use of such support as the Internet. It is based on the establishment of functional equivalent for paper-based concepts such as "writing", "signature" and "original". By providing standards by which the legal value of electronic messages can be assessed, the Model Law should play a significant role in enhancing the use of paperless communication. In addition to general norms, the Model Law also contains rules for electronic commerce in specific areas, such as carriage of goods. With a view to assisting executive branches of Governments, legislative bodies and courts in enacting and interpreting the Model Law, the Commission has produced a Guide to Enactment of the UNCITRAL Model Law on Electronic Commerce.³²⁰

Some other International Organisations working and developing strategies on the subject are International Chamber of Commerce (ICC), International Telecommunication Union (ITU), International Trade Centre (ITC), and International Fiscal Association (IFA).³²¹

5.c.. The Role Of Business Sector

In addition to the need for consensus between governments, there is also a need for co-operation between governments and business. There will need to be an integrated review of how the Internet will impact on tax systems; on legislation and administrative regulations; on implementation and audit practices; and on international taxation arrangements. As one of the main international actors, OECD Committee on Fiscal Affairs (CFA) emphasises that it is ready to work with other regulatory and administrative bodies and the business community. However, the business community

³¹⁹ ITC, *Secrets of e-commerce*, for further information, see: www.untpdc.org

³²⁰ Johnson James A., *Report on International Organisations*, nii.nist.gov/pbs/intl_org.html, for further info see; www.uncitral.org

³²¹ for further information see ITC, *Secrets of E-com*, p.227

must stand ready to work with tax authorities to ensure that these new ways of doing business do not place unacceptable administrative burdens.³²²

The Sacher Report underlines the responsibilities of governments in providing appropriate regulatory frameworks while adapting their own administrative procedures and processes to remain tuned to the new developments. It adds "Electronic commerce should remain market-driven so that many of today's difficult problems can be overcome through the competitive interplay of market forces".³²³

A new partnership between governments and business has become a requirement in almost all sectors in the search for realistic solutions that will take full account of the diverse interests concerned.³²⁴

The private sector has been playing a pioneering role, for example, in the process leading to landmark global agreements such as the Information Technology Agreement (ITA) and the Mutual Recognition Agreements on conformity assessment (MRAs).³²⁵

Application of existing taxation principles to the electronic medium must also be built upon tools that businesses already use or are required to develop to meet their market needs. Tax obligations should especially fit into the new streamlined processes found in electronic commerce. It is only in this way that high tax compliance can be sustained with the least burden and the fewest economic distortions.³²⁶

According to Sacher Report, "in order to ensure close communication with industry, governments should give early consideration to the development of high-level statements outlining proposed actions of relevance to Electronic Commerce, along with time scales. To ensure the productive co-ordination of public and private sector agendas for the application of Electronic Commerce, every government should have a Chief Information Officer, or some other highly visible single locus of activity for national information and communication activities. In general, all government actions in areas of importance to Electronic Commerce should be given high visibility in order to generate and sustain public confidence and trust in the emerging Electronic Commerce environment."³²⁷

³²² OECD, Turku Summit

³²³ Sacher Report p.4

³²⁴ *ibid* p.4

³²⁵ EU Commission, A European Initiative in E-Commerce, *Com(97)157*, 15.04.1997, p.7

³²⁶ GIIC, Dialog Beyond G-8, p.1

³²⁷ Sacher Report, p.15

Public sector practices must be made responsive to the substantial changes in the business environment that are expected to occur with the diffusion of Electronic Commerce. This applies particularly to procurement practices, and to all administrative reporting procedures that are required of industry by governments.³²⁸

Tax authorities must be encouraged to create an intensified working relationship with the business community on the issues relating to electronic commerce. The use of partnership working groups between business and government to address the numerous detailed issues to be addressed is highly endorsed. Tax authorities should open this process broadly to interested business participants and ensure the widespread support of the business community. Even greater openness is called for to ensure timely and valuable input by those in the business community who have much to offer to this process.³²⁹

In one of its communication EU Commission stressed this need as: *Work towards global consensus from a common European position to ensure effective participation in current international co-operation and negotiation.* Europe should identify its own strengths and interests and argue accordingly in the international forums and groups best suited for this purpose.³³⁰

³²⁸ Sacher Report, p.15

³²⁹ GIIC, Dialog Beyond G-8, p.2

³³⁰ EU Commission, *A European Initiative in E-Commerce*, Com(97)157, 15.04.1997, p.8

developing countries. The best way to ensure long-term economic prosperity, quality services and the continued creation of new jobs is to ensure the future growth of electronic commerce.³³³

Numerous forms of cross border electronic business will likely to develop in the coming years as bandwidth becomes wider and less costly, computer processing speed become faster, and memory becomes less expensive. The existing set of rules in the international tax area is often ambiguous at addressing these new commercial applications.³³⁴

For taxation activities, however, whether inside a company or inside a state or local government, this migration of business from the *real world* to the *virtual world* poses some difficult and even vexing problems. For example, when does a company have to pay state or local sales tax on a transaction? How does it collect that information then pay it to the proper governmental entity? How does a state or local government protect its sales tax base with the growing encroachment of e-commerce?³³⁵ Do e-commerce activities rise to the level of a taxable presence, providing a jurisdiction with the right to tax the income? Should the income from e-commerce activities be characterised as sales income, services income or royalty income?³³⁶ What is the law on these emerging problems?

Thus, it is important not just to be on the Web with e-commerce, but to also play by the rules—whatever they may be—.

Ch.1.. Various Types of Taxes for Various Countries

In general , law is defined as 'a compilation of rules , norms orders and prohibitions bearing the State sanction and regulations that purport the set of individuals and society in a harmonious manner'³³⁷ Public Finance is also a social science and its focal point is also well being of 'the human'.³³⁸ As a branch of public law fiscal law deals with the financial aspects covering taxes and all monetary legislation related with the state fiscal regulations.³³⁹ Today it is impossible for a state to administrate and use its sovereignty rights on its citizens without making public expenditures. Naturally a state

³³³ GIIC, Dialog Beyond g-8, p.13

³³⁴ FRIEDEN K., Cybertaxation , p.436

³³⁵ EPP Tod, An Internet Tax Primer

³³⁶ FRIEDEN K., Cybertaxation, p.436

³³⁷ ADAL Erhan, *Fundamentals of Turkish Private Law*, Beta Yayınları, 5th edition, İstanbul 1998, p.1

³³⁸ TÜRK, İ., *Kamu Maliyesi*, 3.Edition, Turhan Kitabevi, Ankara 1999, p.5

³³⁹ ADAL E., *Fundamentals of Turkish Private Law*, p.1

PART3: INTERNATIONAL ASPECTS OF E-COMMERCE TAXATION

General

As the e-commerce world spins furiously, governments from around the world are increasingly concerned about its impact on taxation, the life blood of all governments.³³¹

Taxation authorities from around the world are concerned by the potential increase in tax avoidance and at the possible shift in the allocation of tax revenues from different governments and jurisdictions. E-commerce makes it possible for business to be conducted in a particular location without any physical presence. Traditionally, this is the key factor in allocating taxing rights between different taxation jurisdictions. E-commerce also removes a number of natural tax collection points from the tax system.³³²

Many taxation issues are not new or unique to electronic commerce but have already developed in conventional commerce, which increasingly relies on new modes of communications and increasingly crosses national borders. The mode of doing business through electronic commerce may add new layers of difficulty and may require solutions to both the problem of no taxation or double taxation and to the problem of administrative burden.

Simplicity, clarity, and fairness must be promoted in both national tax regimes and supranational (e.g. the European Union's value-added tax system), as well as bilateral tax agreements for the avoidance of double taxation based on international models, in order to allow for the global trading potential of electronic commerce.

Earlier forms of e-commerce were mostly custom-made, complex, expensive and the province of large firms. Today, for a few thousand dollars, anyone can become a merchant and reach millions of consumers world-wide. What used to be business-to-business transactions between known parties has become a complex Web of commercial activities that can involve vast numbers of individuals who may never meet. In this sense, the Internet and electronic commerce have converted a luxury for the few into a relatively simple and inexpensive device for the many in both developed and

³³¹ EPP Todd, *An Internet Tax Primer*, The Institute of Internal Auditors

³³² *ibid*

needs enough revenue to make the expenditure.³⁴⁰ For an optimal financial situation a state have to decide carefully from which sources, from whom, when and with which methods to take the revenue, also to where and when to spend it.³⁴¹ Law of taxation is in its broad meaning the branch of law which deals with the legal status of the revenues of a state which are collected by the power and sanction of the state.³⁴²

In the history of democracy we see that the first power of the kings which is wanted to be restricted by the people was right to tax. Right to tax can be described as the legal or de facto power of the state about taking revenues from its citizens depending on its sovereignty over the country. This right is the most important of the states' powers in financial area.³⁴³ The legal character of right of taxation changes according to time, the status of the state, the method of administration etc.

In the course of time every country has set up an elaborate system of taxation for generating government revenue and for correcting undesirable effects of the working of markets. The structures, rates and exemptions of these systems reflect a number of choices about functions of government in allocation, stabilisation and redistribution. Such systems affect the relative price of goods, services, labour and capital.³⁴⁴ In line with the principles of nation state and independence of states, states have a very high amount of autonomy in tax matters. Nations have maximum sovereignty and flexibility in arranging their own tax systems. This causes a high variety in taxation systems and kinds of taxes. We will examine here the most common kinds of taxes for all countries.

Ch.2.. Direct Tax (Income etc) Issues

Direct taxes are tax on income — the most common form of tax. They are usually the most important source of tax revenue for most jurisdictions.

E-commerce threatens direct taxes in several ways:

- Disintermediation: that is, the reduced role played by businesses that have traditionally operated at marketing points between the manufacturer/importer and the consumer, e.g. wholesalers, brokers, agents etc.;³⁴⁵
- fixed place of business
- characterisation of income:

³⁴⁰ TÜRK, İ., Kamu Maliyesi, 3.Edition, Turhan Kitabevi, Ankara 1999, p.2

³⁴¹ MUSGRAVE, Richard A., Maliye Politikası, Alkım Yayınları, İstanbul, no date, p.27

³⁴² ÖNCEL M., KUMRULU A., ÇAĞAN N., Vergi Hukuku, Turhan Kitabevi, 6th Ed., Ankara 1998, p.3

³⁴³ ÖNCEL M., KUMRULU A., ÇAĞAN N., Vergi Hukuku, Turhan Kitabevi, 6th E., Ankara 1998, p.33

³⁴⁴ MATHEW Karl, The Economics of European Integration, p.376

- transfer pricing³⁴⁶

Some argue that it is unlikely that e-commerce will have any significant impact on direct taxation (e.g. income tax, corporation tax and taxes on profit) in practice.³⁴⁷ There are two main areas in which clarity needs to be established. One is the determination of the character of income that is generated by the E-commerce transaction: is it royalty, business profit, or fees for technical services? The other area is the determination of what constitutes a permanent establishment in the source country and attribution of income to the permanent establishment.³⁴⁸

The existence of a “fixed place of business” (business nexus) or a *permanent establishment* allows a tax jurisdiction to tax income derived by a non-resident from sources within that jurisdiction. Traditionally, a fixed place of business involves an office, a factory, a workshop, or a dependent agent of the business. The communications revolution undoubtedly makes it easier for non-residents to conduct substantial business activities (and derive substantial income) without having a fixed place of business in a country.³⁴⁹ Selling electronically is an obvious opportunity for a business to either reduce or avoid a tax footprint outside the country where it is resident. A business will still be liable to tax where it is resident, but it does not necessarily have to have a taxable presence elsewhere to meet its commercial objectives.³⁵⁰

A substantive issue raised by new communication technologies is identifying the country or countries, which have the jurisdiction to tax income. Whether a web server and an Internet Service Provider (ISP) will constitute a Permanent Establishment (PE) or not are questions which have been haunting policymakers. The traditional concept of source-based taxation may lead to a global migration to low tax or tax haven countries. Any attempt to artificially tax e-commerce will also accelerate such migration. Therefore **residence-based taxation** is being advocated by many countries, with the U.S. being one of its main proponents. However, determining residence itself is likely to be problematic.

Classification of income arising from transactions in digitized information, such as computer programs, books, music, or images is also an issue that requires consideration. The distinction between royalty, sale of goods, and services income must

³⁴⁵ ATO, Tax and the internet, p.159

³⁴⁶ EPP Tod, An Internet Tax Primer

³⁴⁷ SCHULZ C., Dont Panic Do E-commerce

³⁴⁸ EPP Tod, An Internet Tax Primer

³⁴⁹ New Zealand Tax Office, E-commerce Report

be refined in the light of the ease of transmitting and reproducing digitized information.³⁵¹

Ch.2.a.. Jurisdiction-Right of Taxation

Most states tax income on the basis of both the source of the income and the residence of the person earning that income. States generally impose tax on all income sourced in their jurisdiction, whether it is derived by resident or non-resident taxpayers (*the source principle*). Countries generally impose tax on the worldwide income of its tax residents, citizens and corporations generally on a current basis. This is referred as the *residence principle* of taxation.³⁵²

As stated above, countries tax the income of persons (individuals or corporations) based on two types of jurisdiction: resident (domiciliary) jurisdiction and source (non-residential) jurisdiction. *Domiciliary or resident jurisdiction* is based on the personal status of the person and refers to residence or temporary place of abode of individuals and to incorporation of effective management with regard to corporations. Resident jurisdiction includes the right to tax the world income of the person involved. The territorial connection justifies the exercise of taxing jurisdiction because a taxpayer can be expected to share the costs of running a country which makes possible the production of income, its maintenance and investment, and its use through consumption.

Where there is no physical presence, source country taxation is generally *non-residential jurisdiction* (source jurisdiction) taxation. This arises when the source of the income is in that country i.e. has reasonable nexus with the territory. For many of the countries non-resident taxation is restricted to specific types of income and the source of income is generally located where the economic activities creating the income occur.³⁵³

Since source jurisdiction is considered to take precedence over domiciliary jurisdiction, the domiciliary state taxing world-wide income will have to take action to remove double taxation that results from the concurring tax claims arising from source jurisdiction in other countries.³⁵⁴ Because of that the states make International Agreements to avoid double taxation. In such cases they prefer to treat the income

³⁵⁰ SCHULZE C., Dont Panic do E-Commerce, p.61

³⁵¹ Confederation of Indian Industry, International Conference on electronic Commerce, *Tax Reforms to Promote e-Commerce in India*, p.6

³⁵² New Zealand Tax Office, E-commerce Report

³⁵³ Langeder Ines, p.48

derived from their jurisdiction by resident or foreign persons or corporations according to the Agreements.³⁵⁵

Under double taxation agreements (DTAs), a resident of one state is normally required to have a permanent establishment in the other (host) state before that host state is able to impose tax on the non-resident's business profits.³⁵⁶ Under income tax treaties, permanent establishment is used as a criterion to determine which country may tax business profits earned by companies directly (i.e. without a separate legal entity) operating in more than one country and which country must take measures to avoid double taxation.³⁵⁷

E-commerce requires no "fixed place of business." Through the Internet, any e-commerce website has a global reach without meeting the traditional criteria of having a business nexus. Many tax jurisdictions have no means of taxing an e-commerce site that operates outside of their jurisdictions but sell to consumers living within their jurisdictions.³⁵⁸

Both the residence and source principles have definitional difficulties that may be exacerbated by the communications revolution. The discussion below focuses on the implications of the communications revolution for the source and permanent establishment definitions (affecting the source principle) and for the centre of management concept (affecting the residence principle).³⁵⁹

Whilst no-one can deny that the residence and source issues surrounding e-commerce warrant examination are they really different to the issues which we already encounter - perhaps on a lesser scale - in relation to physical transactions? For instance, a non-resident can already sell goods into a country without the need to establish residence in that country. Further, such a transaction could easily be structured in a way such that the source of the income from the transaction was also not in that country.³⁶⁰

There has been some discussion as to whether the mere use in electronic commerce operations of computer equipment in a country could constitute a permanent

³⁵⁴ Langeder Ines p.48

³⁵⁵ CTO, Selected Tax Policy Implications of E-Commerce

³⁵⁶ New Zealand Tax Office, E-commerce Report

³⁵⁷ CTO, Selected Tax Policy Implications of E-Commerce

³⁵⁸ EPP Tod, An Internet Tax Primer

³⁵⁹ New Zealand Tax Office, E-commerce Report

³⁶⁰ TOBIN Gilbert, E-Commerce: A Taxing Issue

establishment.³⁶¹ The issue is of equal importance in electronic commerce as it determines how web-site and server locations are treated and how the tax base created by electronic commerce activities is divided.³⁶²

It is important that an international consensus be developed on the issue, to reflect developments in the global trading environment.³⁶³

Ch.2.a.1. Concept of Residence

A taxpayer is generally taxed on its worldwide income in the country of its residence (*'residence based taxation'*). 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. Where dual residence results from the application of domestic criteria, the tax treaty tie-breaking rule is applied and the place of effective management is decisive.³⁶⁴

A taxpayer is generally taxed on their worldwide income in the country of residence (residence based taxation). Where the income or capital is taxed in the country of source, the country of residence has the obligation to give relief from double taxation. Such relief is granted either by accepting such income from taxation in the country of residence or by giving credit for the taxes paid in the source country.³⁶⁵

The communication revolution does not present the same challenge to residence rules as to permanent establishment. It is not as easy to change residence as it is to change the jurisdictional source of income. This is particularly so in most countries, where individual residence is determined primarily by reference to a person's permanent place of abode, rather than solely a length-of-presence test. The communications revolution should not, therefore, make it any easier to circumvent this definition. What this means, in practice, is that if an English resident for instance, suppresses income from electronic commerce, the issue is essentially one of evasion, rather than one of a deficiency in England tax rules that permits the suppression to take place.³⁶⁶

As it stands today, in the context of international electronic commerce activities on the internet, residence-based taxation currently is more important than source-based taxation. The US Treasury Paper mentions '*... transactions in cyberspace are likely to*

³⁶¹ OECD, Clarification of Permanent Establishment Definition in E-Commerce , p.5

³⁶² GIIC, Dialog Beyond G-8, p.2

³⁶³ New Zealand Tax Office, E-Commerce Report

³⁶⁴ Confederation of Indian Industry, Tax Reforms to Promote E-Commerce in India, p.6

³⁶⁵ *ibid* p.5

accelerate the trend to de-emphasize traditional concepts of source-based taxation, increasing the importance of residence-based taxation.³⁶⁷

A globalised company will mean one with management scattered around the globe, communicating by telephone, fax, e-mail or video conferencing. It would be difficult to confine the result of such management to one location. In the case of management elements scattered over more than one jurisdiction, under the traditional residency concept, one of those locations has to be nominated as the main management location. Under those concepts, it should be investigated whether the other locations are to be considered Permanent Establishments.³⁶⁸

2.a.2. Permanent Establishment

The general rule for business income is that *it should be taxed in the countries where the entrepreneur possesses permanent establishments*. The meaning of the term permanent establishment has remained largely unchanged ever since, although extended and adjusted to new forms of business activities. The term denotes the threshold to the level business activities in the source countries must have reached in order to entitle that country to tax the income. Generally source income that cannot be attributed to a permanent establishment in a country can only be taxed in the state of residence.³⁶⁹ Treaty definitions of permanent establishment typically require more activities, or more physical presence to rise to the level of taxation.³⁷⁰

A permanent establishment is defined as *"a fixed place of business through which the business of an enterprise is wholly or partly carried on."*³⁷¹ The basic rule in the OECD Model Tax Treaty is that business profits are taxable in the source jurisdiction only if they are attributable to a permanent establishment in that jurisdiction.

Basically, the relevance of the notion of PE (under Double Tax Treatments) is that, in simple terms, a person may only be taxable in a foreign country (ie., a country where they are not resident) if they have a PE in that country. In an e-commerce environment, the issue has arisen as to whether the existence of a website and/or server in a foreign country will constitute a PE with the consequence that the foreign

³⁶⁶ New Zealand Tax Office, E-commerce Report

³⁶⁷ Confederation of Indian Industry, Tax Reforms to Promote E-Commerce in India, p.11

³⁶⁸ *ibid* p.11

³⁶⁹ Langeder Ines, p.49

³⁷⁰ FRIEDEN K, Cybertaxation, p.454

³⁷¹ OECD, Model Tax Treaty Characterisation Issues Arising from E-Commerce

country will have taxing rights in relation to profits attributable to the activities of that PE.³⁷²

The main characteristics of a permanent establishment changes according to the laws of different states but most common the permanent establishment is every fixed place of business that serves the activity of the enterprise. For example the place of management gives rise to permanent establishment, as well as branch establishments, production sites and factories, storage facilities, buying sites, sales and marketing offices, landing stages for ships, offices and other devices serve a place of business. Furthermore for most countries building activity that has lasted or expected to last more than six months results in a permanent establishment.³⁷³

Tax conventions have always looked to significant business activities requiring both *fixed physical facilities* and the *presence of persons* - employees or dependent agents - who are engaging in business activities on behalf of an enterprise. For example, tax conventions have never attempted to trace the location of specific interactions or transactions over the telephone lines or the sites of specific conversations or negotiations.³⁷⁴

As a policy matter, both a *fixed place of business* and *personnel* should be required in any determination of a permanent establishment. To focus only on the physical presence of a certain piece of equipment, like a server or an intangible such as a website regardless of personnel as a basis for taxation would cause erosion of the existing international consensus with respect to the fundamental requirements for taxing cross-border business profits, and would undermine international commerce.³⁷⁵

Existing principles, with only minor clarifications to add certainty and consistency, are sufficient. The fundamental concepts of permanent establishment are not significantly threatened, despite dire warnings from some quarters, and radical changes to, or rejection of, the fundamental principles is not warranted at this time.

Most definitions of permanent establishment comprise four elements: a-) the existence of a 'place of business, b-) the fixed nature of this place of business, c-) the serving of the enterprise through this fixed place and d) more than only temporary dominion and control.³⁷⁶

³⁷² TOBIN Gilbert, *E-Commerce: A Taxing issue*, qlaw.com.au/t/publication/default.jsp?pubid=259

³⁷³ INES L., p.50

³⁷⁴ GIIC, *Dialog Beyond G-8*, p.3

³⁷⁵ *ibid*

³⁷⁶ INES L., p.50

The permanent establishment is also defined in Article 5 of OECD Model Tax Convention. According to the above stated definition, it requires three elements: a-) the existence of a 'place of business' b-) the fixed nature of the place of business and c-) the carrying on of the business of the enterprise through this fixed place.³⁷⁷

OECD Contribution to PE Concept

The OECD has taken a leadership role in reviewing existing taxation frameworks relating to e-commerce, with important progress now being made on issues ranging from consumption taxes to tax treaties and the tax treatment of digitised goods such as software. In a recent effort to apply the existing domestic and international arrangements to electronic commerce, the OECD is working to update the OECD model income tax treaty with a commentary on the concept of *permanent establishment* in the context of electronic commerce.

In October 1999, a Working Party on Tax Conventions and Related Questions of the OECD's Committee on Fiscal Affairs was charged with updating the OECD commentary addressing how the concept of permanent establishment under the treaty applies in electronic commerce. The basic rule in the OECD Model Tax Treaty is that business profits are taxable in the source jurisdiction only if they are attributable to a permanent establishment in that jurisdiction. A permanent establishment is defined as "a fixed place of business through which the business of an enterprise is wholly or partly carried on." A place of business is described in the OECD Commentary as "premises, facilities or installations."

In March 2000, the working party released a revised draft and provided a summary of views of member countries on factors that constitute permanent establishment. Various views on whether the use of computer equipment for electronic commerce operations constitutes a permanent establishment in the country in which the computer is located were expressed. Some representatives said this issue is already addressed in the existing commentary, which recognises that business can be carried on through certain equipment. Other representatives disagreed, saying that electronic vendors, for example, could change locations every week and that would not constitute a fixed place of business. Arguments were also made questioning whether human intervention was necessary for the automated equipment to constitute permanent

³⁷⁷ INES L., p.59

establishment and the amount--from some to none of human intervention required to constitute permanent establishment.³⁷⁸

The view that has been reached by the OECD TAG addressing this issue, is that the existence of a website on someone else's server (ie. ISP) will not constitute a PE. However, if a person maintains a server (whether owned or leased) it is possible, depending on the activity carried on through the server, that a PE may be created. For example, if the activities performed by the server can be regarded as preparatory or auxiliary (eg., providing a communications link, advertising of goods and services, relaying information from a mirror server, gathering market data and supplying information) then the mere existence of the server will not of itself give rise to a PE.

If, on the other hand, *the server is involved in actually performing functions which are an essential and significant part of the business activities*, then it is likely that it will constitute a PE. An example of this may be a situation where an e-tailer has a server located in a foreign location which performs functions - including the conclusion of customer contracts, processing of payment and delivery of products.³⁷⁹

A related question is that of the passive use of an asset for operational reasons. The European Court of Justice had occasion to consider whether such use would amount to a PE in a judgment of July 4, 1985. 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 can be a piece of equipment (such as a vending machine), but subject to the provision that it is permanently installed at a specific location and that it requires the employment of human energy for its operation.³⁸⁰

Detailed analysis will be given below whether a web-site, server or Internet Service Provider (ISP) constitute a permanent establishment.

Ch.2.a.2.1. Web Server-Site-ISP etc. as Permanent Establishment

1.a. The Presence of a Web Site as a Permanent Establishment

A website can be defined as a software application that may contain advertising, which is located on space in a computer server's memory. This space is like a group of

³⁷⁸ GIIC, Dialog Beyond G-8, p.4

³⁷⁹ TOBIN Gilbert, *E-Commerce: A Taxing Issue*

³⁸⁰ Confederation of Indian Industry, Tax Reforms to Promote E-Commerce in India, p.13

computer files, with its own address and affiliation. The server must be both capable of running Web server software and connected to the World Wide Web.³⁸¹

It is often discussed whether the vendor's website creates a permanent establishment in the source country. The website consists only of files. Unless these files are stored no fixed place of business can exist for the simple reason that there is no link to a certain location, not to mention the necessary permanence.³⁸²

A web site has no actual physical presence, but rather is highly mobile, borrowing only the presence of the server where it happens to reside at the moment. No employees need be present in the country to maintain the site. To the extent that advertising and ordering functions are performed, the web site is analogous to a mail order catalogue or a television advertisement, "infomercial" or home shopping channel. Mere solicitation, without more, does not create a permanent establishment under existing principles, and it should not when effectuated through electronic commerce. And to the extent that a customer can view stock or data, the web site is analogous to a location being maintained solely for the purposes of storage, display or delivery. Moreover, under existing principles, electronic content that resides on a server only temporarily should not be a permanent establishment.³⁸³

A web site, because it does not meet any criteria of existing definitions of permanent establishment, is not a fixed place of business or a permanent establishment. While it is entirely possible that some jurisdiction somewhere in the world may be able to develop an argument that a web site is a fixed place of business³⁸⁴, this will bring about additional legal problems to be solved. As a web site can be reached from all around the world; it results possessing a PE in any country where the site can be reached. Since getting access to a web-site is possible from every country, individual states might have the right to claim PE for taxing rights. As this is legally impossible and unacceptable, a web site cannot be considered as a permanent establishment.

The GIIC believes that in light of the need to interpret existing tax conventions, clarification should be provided that the existence of a web site on a server alone, absent a further fixed place of business, does not result in a permanent establishment.³⁸⁵

³⁸¹ CAYO Carol, Straight Talk:Internet, Tax and Interstate Commerce, itaa.org/govt/pubs/stalk.html

³⁸² ESPRIT, Tax Aspects of International E-Commerce, p.26,eclip.org/documents/ll/research/tax2.pdf.

³⁸³ ESPRIT, p.16-20

³⁸⁴ Cybertaxation, p.452

³⁸⁵ Taxation GIIC p.4

Web sites through which sales are made cannot constitute a taxable presence in another country. A web site alone is not a fixed place of business and so does not create a taxable presence in another jurisdiction. Only if the business to which the web site belongs also owns or rents the server, and if the activity carried out via the web site is not within the normal exclusion for preparatory or auxiliary activities, will a taxable presence exist.³⁸⁶

1.b. The Presence of a Server as a Permanent Establishment

The internet has been described as, "a spider's web of connections among hundreds of thousands of computers."³⁸⁷ It works by allowing a user to access data that resides in memory on a network server. The server could be located anywhere, in any jurisdiction that is attached to the internet. Data does not necessarily follow the same path from provider to user, instead following the best route available, moving at random between interconnecting computer servers.³⁸⁸

National differences aside, the major issue about permanent establishment in the context of electronic commerce is whether a server can be considered to constitute a permanent establishment. A server is a small microcomputer with large backing storage device that is used for the management and storage of the user's files in a network, e.g. the Internet. Such files stored on a server may represent a vendor's web site containing software merely for advertising or collecting information, an electronic catalogue or 'intelligent agent' software which provides facilities for the immediate downloading of digitised products.³⁸⁹

Of itself, a website is not likely to give rise to the construct of a permanent establishment. The website as a combination of files is not fixed in the sense of existing laws. The function of the server, understood as the mere hardware equipment, must be seen in providing a platform for the website which is accessible through the Internet.

As a tangible asset, a server can be considered to constitute a place of business, presupposing that it is at the disposal of the vendor. If the vendor maintains his own server in the source country or is the sole user of the whole server, or at least a specific capacity of the server, this condition of being a fixed place of business could be fulfilled. However, when one takes into account the maintenance requirements of the server, a vendor will seldom deploy his own equipment abroad, rather, he will use a third party

³⁸⁶ Dont panic do E-com p.62

³⁸⁷ Selected tax policy

³⁸⁸ Cybertaxation, p.457

³⁸⁹ ESPRIT, p.16

server which is generally operated by a domestic Internet Service Provider (ISP). In such cases the test might fail.³⁹⁰

The hardware equipment on which the vendor's website is stored is located in a certain point on the earth's surface. It therefore establishes a fixed place of business. In sense of time a 'certain degree of permanency' is necessary. Since a web site can be moved easily from one server to another, this raises the question under which circumstances a temporary storage constitutes a fixed place of business. The emphasis is on the intention of the enterprise in setting up the website on the specific server. A place of business has a certain degree of permanence if it is not of a purely temporary nature. But how much time can be considered purely temporary? A foreign vendor who tries to avoid giving rise to the inference of a permanent establishment can rent servers for a short period of time or physically move his own server. If a place of business is regularly relocated within a country even a total stay of more than a year might not sufficient to give rise to a fixed place of business. Taking the permanent establishment concept seriously, an activity carried out from different places cannot be considered fixed in a certain location if a server is moved between different jurisdictions or the rented servers are situated in different jurisdictions the picture might change slightly. Similar to conventional moving activities a permanent establishment should not be found in such cases. However, this assessment is far from secure. *Regular appearance in a country might, of itself, suffice to create a permanent establishment.*³⁹¹

Will a server constitute a PE? Does a web server located in a jurisdiction other than the country of residence of the person owing or controlling such a server, form a PE? This issue can be analyzed under four sets of circumstances:

- (i) where the server is used merely for advertising
- (ii) where the server is used for advertising and taking orders
- (iii) where the server is used for advertising, taking orders and accepting payments; and
- (iv) where the server is used for advertising taking orders and accepting payments and for digitized delivery of goods. In the first case, a server will not be held to be PE. Exception will be attracted in this case where the use of a facility solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise will not amount to the existence of a PE. The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any activity of a preparatory or

³⁹⁰ ESPRIT, p.16-20

³⁹¹ ESPRIT, p.16-23

auxiliary character from the ambit of PE will also be exempted. Where such activities or functions are of a preparatory or auxiliary nature, the server should not constitute a permanent establishment. In the second and the third case, it may possibly be held that the server is a PE. In the last case, there is an even stronger case to hold the server to be a PE. However, an attempt to tax the server as PE will not serve any purpose as it is very easy to shift the server to a tax haven or to a low tax country. Further, difficulties will arise where a number of mirror web sites on different servers located in different countries are used so that a customer could be directed to any one of these sites.³⁹²

The GIIC urges a clarification that, under existing principles, the presence of a server alone in a country, without more, is not in itself a sufficiently "fixed place of business" to constitute a permanent establishment. Certainly, the presence of machinery alone does not constitute a permanent establishment under existing tax treaties.

Moreover, the principles underlying the existing tax treaties consistently look to the activities and locations of persons - employees or dependent agents - who are engaged in business activities in a country. Thus, even if the presence of a piece of equipment such as a server were sufficient to constitute a fixed place of business, the determination of permanent establishment must look beyond the mere presence of the server to the presence of personnel, the functions they perform using the server, and the nature of the activities for which it is used, and other indicia that the business of an enterprise is being conducted through a permanent establishment in the country.

Finally, a finding of permanent establishment requires a certain element of permanence, given the ability of businesses to structure their electronic commerce operations to move servers, databases, software, and server operations at will, to use mirror servers or server arrays, and to build redundancy into their hardware platforms. The functioning of the business activity is not dependent on the server being in a particular location, and an in-country location does not convey any business or economic advantage. Moreover, the use of a server is no more integral to the enterprise's business activity than the use of telephone equipment is to an enterprise that is not in the telephone business. Jurisdiction based on the presence of a server alone is thus rather illusory.

³⁹² India Taxpaper p.12

To treat the mere presence of a server as a permanent establishment would in effect result in new taxation of electronic commerce in violation of the principle of neutrality. Depending on the applicable double taxation relief mechanism business placed in a certain jurisdiction may be encouraged to engage in forum shopping or to seek a tax haven in response to such a policy.³⁹³ Only if the business to which the web site belongs also owns or rents the server, and if the activity carried out via the web site is not within the normal exclusion for preparatory or auxiliary activities, will a taxable presence exist.³⁹⁴

It is believed that a clarification based on existing principles that a server does not in itself constitute a permanent establishment will contribute to greater certainty, simplicity, and ease of enforcement by eliminating the otherwise overwhelming server-by-server (and software-by-software) determination.³⁹⁵

1.c..Internet Service Providers as to be Agents for Purposes of Determining the Existence of a Permanent Establishment

The ISP that provides access for the vendor might create a permanent establishment in the source country. The ISP allows the vendor to place its website in the Internet, either by making the vendor's own server approachable or by leasing memory capacity to the vendor to store the files the website consists of. To enable customers to trace the vendor the ISP assigns an address to the space the website is stored in. Having gained access the customers are free to select the address thereby accessing the vendor's website.³⁹⁶ As already noted, it is common for ISPs to provide the service of hosting the web sites of other enterprises on their own servers.³⁹⁷

Under existing rules, an enterprise is deemed to have a permanent establishment if it has a dependent agent in the source state that habitually exercises the authority to conclude contracts that are binding on the enterprise. The use of independent agents does not result in a permanent establishment.

Perhaps there might be hardware equipment other than the server and telecommunications network used by the ISP to gain access to the Internet. Since this equipment is normally neither owned nor rented nor otherwise at the disposal of the vendor, will not create a fixed place of business. Thus, the ISP is usually an

³⁹³ Taxation GIIIC p.5

³⁹⁴ Don't panic do ecom

³⁹⁵ Taxation GIIIC p.5

³⁹⁶ ESPRIT, p.29

³⁹⁷ OECD, *Clarification of Permanent Establishment Definition in E-Commerce*, M00015535

independent person. For independent persons there is an exception. A person who does not act in the ordinary course of his business when acting on behalf of the enterprise cannot be considered independent of the enterprise and can, consequently, qualify as a permanent establishment. However, as an ISP hosting a website and providing access to the Internet acts in the ordinary course of business this exception does not apply with regard to the ISP providing services to the vendor.³⁹⁸

The issue may then arise as to whether such ISPs to constitute permanent establishments of the enterprises that carry on electronic commerce through web sites operated through the servers owned and operated by these ISP. While this could be the case in very unusual circumstances, generally, because the ISPs will not constitute an agent of the enterprises to which the web sites belong, they will not have authority to conclude contracts in the name of these enterprises. So they will not regularly conclude such contracts or because they will constitute independent agents acting in the ordinary course of their business, as evidenced by the fact that they host the web sites of many different enterprises.³⁹⁹

The ISP merely acts as an intermediary between a non-resident seller and the customers in the source country. Therefore, the ISP will not qualify as the agent of the non-resident seller. Since the ISP acts on behalf of several web site owners, even if it is treated as an agent, it would be an independent agent and not a dependant agent. Therefore, it will not constitute a PE. Even if it acts for only one website owner, it does not have the authority to conclude contracts on behalf of the web site owner, which is an essential pre-requisite before it can be considered to be the owner's PE.⁴⁰⁰

Certainly, an Internet service provider is no more a dependent agent than a telephone service provider, a mail courier, or a common carrier. If in fact there is a legal agency relationship at all, then the Internet service provider would be an independent agency if it is acting in the ordinary course of business and if it is legally and economically independent of the enterprise.⁴⁰¹

Tax authorities should clarify that the existing rules of agency apply - that an Internet service provider which is economically and legally independent of the enterprise, and is acting in the ordinary course of business, is not a dependent agent and will not constitute a permanent establishment of the enterprise. This analysis also

³⁹⁸ ESPRIT, p.29

³⁹⁹ OECD, *Clarification of Permanent Establishment Definition in E-Commerce* M015535

⁴⁰⁰ India Taxpaper p.13

should apply; for example, to telecommunications service providers, other online service providers, and web site hosting arrangements.

Modems, routers and other ancillary telecommunications equipment should not be regarded as - PE as they do not form a significant part of the equipment carrying on any business activity. Web server per se, should not be regarded as PE, especially where it is used only for advertising or procurement of orders. ISPs should not be regarded as agents and should not be deemed to constitute PE.⁴⁰²

Ch.2.b...Characterisation of Income

2.b.1..Impact of Electronic Commerce on the Classification of Income

The use of the Internet for the distribution of information products both facilitates commerce and threatens its traditional income classification module. On the one hand, the universality, the speed, the efficiency with which information products can be sold reduces transaction costs and puts businesses directly in touch with a global market. On the other hand, the very technologies that facilitate networks for the electronic storage and transfer of data enable the unauthorised reproduction and redistribution of information products.⁴⁰³

The application of tax laws depend in some areas on the nature of the income in question. For instance, only certain types of income are subject to withholding taxes (e.g., royalties) and, the taxation of income earned from sources outside of a state or by non-resident persons from sources within this state is dependent on the classification of that income.⁴⁰⁴ So, the application of source rules will vary depending upon the nature of the income.⁴⁰⁵ The application of tax law to cross-border transactions frequently requires that the character of the income be determined for tax purposes. Different tax consequences will flow, depending on the character of the income.⁴⁰⁶

With the transformation in the mode of delivery and form that a product takes in an e-commerce environment, this has resulted in questions being raised as to whether e-commerce also transforms the nature of the income being earned.⁴⁰⁷

⁴⁰¹ Taxation GIIC p.6 US

⁴⁰² India taxpaper p.4

⁴⁰³ GAIL E Evans and FITZGERARD Brain, *Information Transactions*, University of NSW Law Journal , auslieduu/journals/UNSVLJ/46htm#fn200

⁴⁰⁴ Cybertaxation , p 468

⁴⁰⁵ Gilbert Tobin

⁴⁰⁶ Tax and the Internet p.

⁴⁰⁷ Gilbert Tobin

Information that can be digitized is generally protected by copyright law. Payments made for the use of or for the privilege of using copyrights are considered royalties. Similarly the U.S. Model Tax Convention defines "royalties" as "payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films." It is not always clear how this definition applies to the sale of digitized information. Yet, it is clear that some of these transactions, such as the electronic purchase of computer programs, are merely substitutes for conventional transactions involving physical objects.⁴⁰⁸

Owing to developments in technology, it is possible to sell books, music, software, etc. electronically as well as physically. This raises significant issues of classification of income. It is possible to view these transactions in terms of the sale of the said items or, as permission for the use of royalty. In case of the former, the income earned will amount to business income and the country of source cannot tax the same in the absence of a PE of the seller. In the latter case, the income will be royalty and taxable even in the absence of a PE. While analyzing the transactions involving digitized 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. While analyzing a service transaction, its predominant characteristics have to be considered, to determine where the services will be taxable.⁴⁰⁹

Tax authorities may feel the need to develop internal rules on the characterisation of software transactions for tax purposes, and develop rules to distinguish software transactions that constitute licensing transactions from those that constitute sales of property.⁴¹⁰

The GIIC encourages the development of an international consensus on guidelines in this area. Moreover, eliminating the need to distinguish between such forms of income would greatly simplify direct taxation, and would result in a more neutral treatment of transactions involving digitised products and more conventional

⁴⁰⁸ Selected Tax policy

⁴⁰⁹ India Taxpaper p.13

⁴¹⁰ JILT A review of contr.

transactions involving the same content or rights. It also would minimise the double taxation which at present all too often results from current withholding tax regimes.⁴¹¹

2.b.2. OECD Work on the Issue of Characterization of Income

A separate Technical Advisory Group (TAG) of the OECD is working on the characterisation of electronic commerce payments. A draft TAG report examined activities such as online shopping, online auctions, subscription-based interactive World Wide Web sites, and electronic ordering and downloading digital products. Determining the character of a transaction is an important step in analysing its tax implications, whether a transaction gives rise to income from sale of goods, income from provision of services, royalty income, or some other category of income. Characterisation issues for electronic commerce include drawing distinctions between various types of payments in determining whether a particular electronic commerce payment, e.g., a payment made for electronically searching a computer database and downloading a document from it, is made for the sale or lease of property.

The draft report said ordering and downloading digital products raised "a fundamental characterisation issue, i.e. the distinction between the treaty definition of 'royalties' and business profits." A majority of the TAG said the payments made for such transactions do not constitute royalties but business profits. The minority in the group argued the payment does fall within the treaty definition of "royalties." The draft report addressed single-use software or other digital products that involve a customer receiving the right to use software or other digital products onetime, where the product is downloaded or used remotely. The customer does not have the right to make copies of the product. The majority of the group said it would treat the transaction as a contract for services, while others disagreed. Those disagreeing said it would be important to distinguish between situations where the product is downloaded into a customer's hard disk from those where it is not. The former case, the minority members said, would give rise to a royalty characterisation. The draft report also examined Web site hosting where an Internet provider offers Internet space to be hosted and created by others. The group agreed that under the OECD model treaty, this transaction does give rise to business profits. Other transactions the group said constituted business profits under the treaty were advertising, electronic access to professional advice, online shopping, online auctions, sales referral programs, and real time Web-based broadcasting. On the issue

of what will constitute a royalty, the OECD TAG (as expressed in their final report) stated that: *"The main question to be addressed is the identification of the consideration for the payment ... Where the essential consideration is for something other than the use of, or right to use, rights in the copyright (such as to acquire the types of contractual rights, data or services), and the use of the copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should be disregarded in the analysis of the character of the payment for treaty purposes."*⁴¹²

Clear-cut guidance on when the withholding obligations takes place in using software or other types of digital information is highly desirable. One suggestion would be to look at the grant of a right to commercial exploitation of a digital product as constituting a royalty. Commercial exploitation means marketing, distributing and selling the digital product, while the use of the digital product, which use falls outside the scope of the commercial exploitation, constitutes a business profit or service fee. Even when a licensor grants a right to reproduce a digital product, the consideration does not constitute a royalty on the following conditions: (a) the licensee only has a right to use the digital product by himself (e.g., for back-up, archival, and site license purposes) and (b) does not obtain the right to have third parties use the copies of the digital product for commercial purpose. This standard could apply to software as well as other types of digital products.⁴¹³

2.b.3..Activities Where Income should be treated as Royalties

i) Technical information (e.g., diagrams of a secret manufacturing process): The customer is provided with undivulged technical information concerning a product or process (e.g. narrative description and diagrams of a secret manufacturing process). This represents a payment for the supply of know-how. Payments arising from this category of transactions constitute royalties as they are made for the supply of know-how, i.e. "for information concerning industrial, commercial or scientific experience."⁴¹⁴

ii) Content acquisition transactions (e.g., a website operator pays various content providers for news stories, information, etc.): Online content in order to attract users to the site. Alternatively, the web site operator might hire a content provider to create new

⁴¹¹ GIIC p.

⁴¹² Gilbert Tobin

⁴¹³ OECD Tax Treaty ch. Issues p.

⁴¹⁴ Oecd Tax Treaty Characterisation Issues, p.29

content specifically for the web site. Payment is being made for the right to display the copyright material and, therefore, is for the right to use the copyright.

iii) Electronic ordering and downloading of digital products for the purpose of commercial exploitation: The customer selects an item from an online catalogue of software or other digital products and orders the product electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalogue. The digital product is downloaded into the customer's hard disk or other non-temporary media. The customer acquires the right to commercially exploit the copyright in the digital product (e.g. a book publisher acquires a copyrighted picture to be included on the cover of a book that it is producing)⁴¹⁵. Payment is being made for the right to use copyright in the digital product because the copyright will be used to reproduce and sell the digital product.⁴¹⁶ It is useful to refer to this category of transaction in order to illustrate a case where all its members agree that the payment qualifies as a royalty.⁴¹⁷ Where the site operator pays a content provider for the right to display copyrighted material, the payment would fall under the definition of royalties to the extent that the public display of the content constitutes a right covered by the copyright of the owner of the content. Where, however, the operator pays for the creation of new content and, as a result of the relevant contractual arrangements, becomes the owner of the copyright in the content so created, the payment cannot be for royalties.⁴¹⁸

Ch.2.b.4. Activities Where Income Should be Treated as Business Profits

Electronic order processing of tangible products, updates and add-ons, limited duration software and other digital information licenses, single-use software or other digital product, application hosting (both bundled contracts and separate licences, Application Service Providing ("ASP") , ASP license fees, web site hosting, software maintenance, data warehousing, customer support over a computer network, delivery of exclusive or other high-value data, advertising, information delivery, access to an interactive web site, online auctions, streamed (real time) web based broadcasting fees should⁴¹⁹ be treated as business profits and should be taxed as business profits.

⁴¹⁵ OECD Tax Treaty Ch. P.21

⁴¹⁶ Gilbert Tobin

⁴¹⁷ Gilbert Tobin

⁴¹⁸ Oecd Tax Treaty Ch. P.31

Ch.2.c... Conclusion for Direct Tax Issues:

The concrete tax rules applying specifically to the direct taxation of e-commerce are few. There is little in the way of new rules or new law to address the proper taxation of e-commerce. Rather the states OECD and other international bodies that have addressed the issue have affirmed the application of existing general principles of taxation to e-commerce.

The historic tax rules applied by developed countries have focused the incidence of taxation on the source of the income under consideration. The rise of e-commerce produces an environment in which determining the source of income may be difficult to ascertain. A source tax regime requires the subject income to be properly characterised before it can be properly sourced. The forms of transactions in the e-commerce field add complexity to the proper sourcing of the resulting income. The classification of income is fundamental to tax consequences of the income.

As the significance of e-commerce increases, the pressure on the existing source based tax regimes will be heavy. It would not be inconceivable to witness nations developed specific sourcing rules for e-commerce transactions or to see a migration of tax systems toward a residence based regime that is less difficult to administer and not dependant on determining source and character of items of income.

The goal of tax neutrality is the proper goal for tax authorities to pursue in their taxation of e-commerce. However, the pursuit of tax neutrality under the existing system may be difficult to achieve. As more transactions occur in e-commerce, experience may point tax authorities toward revising their existing income tax regimes to ensure proper administration and compliance.⁴²⁰

Significant studies have been made in direct taxation of e-commerce; nevertheless, it may be necessary to further clarify the applicable principles in this area and seek to create an international consensus on this issue.⁴²¹ To tackle the problem in the long term it may be necessary for revenue authorities to resort to more radical cures. The obvious one which comes to mind is that revenue authorities must open up

⁴¹⁹ For further info *OECD Treaty characterisation issues*. p.22-32.

⁴²⁰ *Cybertaxation*, p.516

⁴²¹ *Selected Tax Policy*

to the international sphere and cooperate much more closely, just like the businesses they are chasing.⁴²²

Ch.3..INDIRECT TAXATION OF ELECTRONIC COMMERCE

E-commerce has developed over the last decade as companies have seen the way in which computerisation and the internet in particular, can significantly accelerate business procedures. It is a truly global business medium, which brings supplier and customer together without actually meeting and without the need for an intermediary. However, the global nature of the medium and the increase in options for product delivery have created new indirect taxation issues. Some of these tax issues raise practical concerns that businesses involved in electronic activities can not afford to ignore.⁴²³

E-commerce has given traditional retailers like bookseller and catalogue retailer a new way to market their goods and services. Almost everything is now available through website-based sales, from fishing equipment to computers to concert tickets to prescription drug refills to name just a few of the myriad of goods and services currently available. This migration of business from the *real world* to the *virtual world* poses some difficult and even vexing problems.⁴²⁴ Thus, the OECD has observed that "[t]he problems concerning the application of consumption taxes are generally recognised as having more immediacy than the issues concerning direct taxation."⁴²⁵

Many tax systems depend on indirect taxes, such as sales taxes, value-added taxes (VAT) or goods and services taxes (GST) to raise a substantial share of government revenues.⁴²⁶ The most common form of indirect taxes are consumer tax or value-added tax (VAT), goods-and-services tax (GST), Sales and Use Tax(SUT) etc. These are taxes based on consumption and paid by the consumer. Sales tax is a form of consumer tax, and is usually levied on the sale of certain types of goods. VAT and GST are more comprehensive and levy consumption tax on goods as well as services (such as haircuts, legal or accounting services).⁴²⁷

⁴²² The horror scope of...

⁴²³ Cybertaxation, p.359

⁴²⁴ Epp Tod, Primer

⁴²⁵ HELLERSTEIN W., *Electronic Commerce and the Challenge for Tax Administration*, WTO Seminars, April2002, Geneva

⁴²⁶ BASU S., 'Taxation of Electronic Commerce', 2001(1), *The Journal of Information Law and Technology*,(JILT), elj.warwick.ac.uk/jilt/01-2/basu1.html, p.12

⁴²⁷ EPP Tod, Primer

For countries that rely on indirect taxation, e-commerce poses a major threat to the tax base. While such countries can impose VAT or GST on the purchase of physical goods that are shipped in from foreign countries by working with the delivery parties (post office, shipping companies, and courier companies), it is difficult for them to impose VAT, SUT or GST on the purchase of services (such as financial, legal, or accounting advice), which have no physical characteristics. Such tax jurisdictions lose the opportunity to tax purchases of electronic forms of goods and services on the Internet because there is simply no means of taxing consumers. Given the general distaste for taxation, it is hard to expect their citizens to remit such taxes voluntarily.⁴²⁸

Due to limitations of available technology, providers of services have until recently made most of their supplies to customers in their own country. *In those circumstances a simple place of supply rule was all that was necessary to define the place of taxation of such supplies.* However the situation is rapidly being transformed by the developments in communications technology such as the Internet. This has created the potential for large scale international commercial activity with the possibility that *suppliers in any country can provide goods and services to customers in any other country.*

For indirect taxation of electronic commerce, reaching agreement on, *inter alia*, defining place of consumption, place of taxation rules and on internationally compatible definitions of services and intangible property⁴²⁹ are very important. In this regard, an internationally co-ordinated approach to ensure the effective application of consumption tax systems to electronic commerce is being sought.⁴³⁰

Ch.3.a.. Implications for Consumption Taxes

Traditional indirect taxation principles for dealing with international transactions are based on the notion that identifiable party physically transfers goods to an identifiable customer. Even where several jurisdictions are involved, a system to determine which country has the right to levy tax has generally evolved. Liability for indirect taxation is typically influenced by the following a) the physical location of goods, b) the residence of the seller and buyer, c) the nature of goods or services being transferred.

⁴²⁸ EPP Tod, Primer

⁴²⁹ OECD, *Taxation Framework Conditions*, p.6, oecd.org/M0001500/M00015517

⁴³⁰ Tax and the internet p.158

The key difference with cyber transactions is that there may be no transfer of actual goods and/or no obviously identifiable physical location at which that transaction takes place. It may also be difficult to determine the geographic location of one or more parties to the transaction, be it the seller, buyer, or intermediary, or even to establish exactly what is being sold. Any of these factors may significantly effect how the transaction is taxed.⁴³¹

E-commerce has made it more practical for end-consumers (those ultimately bearing the incidence of any consumption tax) to source goods and services from outside their jurisdiction. This poses difficulties for the collection of consumption taxes. Unless Customs is able to identify those imports, it may be impractical for consumption taxes to be levied by the country into which the supplies are made.

However, while this feature of e-commerce poses a threat to the integrity of consumption tax bases, it does have its positive side. By exposing domestic consumers more to foreign suppliers, global competition is created. One consequence of this may be the promotion of more efficient distribution of products to the final consumer. It may also result in the breakdown of some inefficient domestic monopolies. Thus, even if consumption taxes can not be imposed, it is still possible that efficiency gains may accrue in the domestic economy.

The three main problems facing governments are:

- defining what is meant by the place of consumption;
- identifying that a transaction has taken place; and
- collecting the tax.

Consumption taxes are often levied through a value-added tax (VAT) or a goods and services tax (GST). *Indirect taxes aim to impose a tax on final consumption in a country and are designed on the basis of the "destination" principle (tax is charged according to the destination of goods and services).* Thus, indirect taxes are imposed on what the country consumes, rather than what it produces. This application is mostly consistent with the international consensus, which is that consumption taxes should accrue in the jurisdiction in which supplies are consumed. The issue for tax policymakers worldwide, therefore, is whether it is more practicable to impose consumption tax on the consumer or the supplier.

⁴³¹ Cybertaxation, p.360

The principal challenge to the indirect taxes posed by electronic commerce is in the area of supplies from off-shore to consumers. It is helpful in looking at the application of the indirect taxes to cross border electronic commerce to consider three broad categories of supplies: a) supplies of physical goods to both business and private consumers; b) supplies from business to business of services or intangible products; and c) supplies from business to private consumers of services and intangible products.⁴³²

a) Supplies of physical goods to both business and private consumers

Supplies of this nature are identifiable in the same manner as physical goods, with imports currently subject to tax at the border, and low value thresholds applying in much the same manner as under the customs system. Tax-free provisions cater for exports of goods. The method of ordering, e.g. electronic, phone or mail, is largely irrelevant in terms of the application of taxation requirements.⁴³³

b) Supplies from business to business of services or intangible products

Supplies in this category are dealt with by the reverse charge mechanism, whereby indirect tax-registered businesses receiving such supplies from off-shore are required to self-assess their tax liability, but only if they would not be entitled to full input tax credits on the supply. Tax-free provisions apply to certain supplies for consumption outside the country.⁴³⁴

c) Supplies from business to private consumers of services and intangible products

To date, no revenue authority has found a practical method for collecting consumption taxes on the third category. *While currently small in volume, this category potentially poses the most significant problem to the effective administration of consumption taxes, and is currently the focus of international attention.*⁴³⁵

Indirect tax revenue may be adversely affected by the replacement of physical goods by digitised products. Digital technology enables products currently supplied in a physical form, and subject to sales tax and duty, to be supplied in an intangible form which places them outside the ambit of sales tax and Customs laws.⁴³⁶

⁴³² Australian Tax Office (ATO Tati-2 Tax and the internet)p.166

⁴³³ Tati-2 Tax and the internet p.166

⁴³⁴ Tati-2 Tax and the internet p.166

⁴³⁵ Tati-2 Tax and the internet p.166

⁴³⁶ Tati 2 p.187

3.b..OECD Work on Consumption Taxes

The OECD is currently considering the taxation administration implications for VAT/GST systems in member countries. An overview of their analysis of consumption tax issues can be found later in this chapter.⁴³⁷

(1) Rules for the consumption taxation of cross-border trade should result in *taxation in the jurisdiction where consumption takes place* and an international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction.

(2) For the purpose of consumption taxes, *the supply of digitised products should not be treated as a supply of goods.*

(3) Where business and other organisations within a country acquire services and intangible property from suppliers outside the country, countries should examine the use of reverse charge, self-assessment or other equivalent mechanisms where this would give immediate protection of their revenue base and of the competitiveness of domestic suppliers.

(4) Countries should ensure that appropriate systems are developed in co-operation with the WCO 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.⁴³⁸

The OECD reaffirmed the principle of territoriality concerning consumption taxes, such that tax should accrue to the revenue authority where supplies are consumed. Without consistency across different jurisdictions on this principle, there is a risk of double or unintentional non-taxation. The OECD is seeking to achieve international consensus on this issue.

Place of supply rules can also differ between jurisdictions for different categories of products. Differences in definitions of goods and services, and place of supply, can create uncertainty about the taxation of such supplies. Unintentional non-taxation or double taxation may result. Therefore the OECD recommends that digitised products are not treated as goods.⁴³⁹

⁴³⁷ ATO, Tax and the internet Tati-2 p.162

⁴³⁸ OECD, Taxation Framework Conditions p.5m00015517

⁴³⁹ ATO, Tati2 p.162

Physical Goods Ordered Over the Internet

The vast majority of sales over the Internet result in supplies of physical products. The existing rules ensure that tax accrues in the country into which the goods are delivered and so there are no significant new problems for indirect taxation.

Since goods have to be delivered by conventional means, Customs will still collect VAT on goods imported from a country at the time of importation and the distance selling arrangements will remain in place. Businesses will not have to make any changes to their existing accounting systems for these transactions. The very sophisticated systems being developed and operated by the fast parcels carriers should ensure that both carriers and Customs can cope with anticipated increases in volume.

3.c..Taxation at the Place of Consumption

3.c.1..The Destination System

Consumption taxes are generally levied in the state of consumption (with regard to the supply of goods often referred to as the state of destination). This system, however, is not consistently applied. Cross-border supplies of goods and services to taxable persons are usually taxed in the state of destination whereas supplies to private customers are mainly subject to tax in the country of origin. This basic distinction currently also applies to electronic commerce transactions. *There is, however, international agreement to aim at taxing the supply of services in the field of electronic commerce in the country of consumption.*⁴⁴⁰

The GIIC supports the general principle of territoriality for indirect taxation. GIIC believes that territorial concepts provide legal certainty, simplicity, and neutrality. While in principle, GIIC does not oppose the principle of taxation at place of consumption, such a system requires particular care to achieving a real consensus toward consistent definitions, rules of classification, and rules for determining where and when tax is due, as well as compliance and refund or credit procedures that do not impose discriminatory burdens on some taxpayers.

The GIIC proposes the adoption of new procedural provisions in tax conventions that would provide mechanisms for taxpayers to address double taxation that may result from inconsistent classifications, definitions, or source of supply rules. Such mechanisms might include credit, exemption, or refund provisions that are easily exercised, are not burdensome, offer timely refunds, and bear interest in the event of excessive delay. While this idea would be quite new in the field of international tax

conventions, it could be a way of using existing tax agreements to cover consumption tax issues.⁴⁴¹

The main issues are therefore in relation to the challenge which e-commerce poses in collecting VAT, SUT or GST on international sales of services between businesses, and especially to private consumers.

Place of taxation rules determine the country in which tax is due on an international transaction. Given the intangible nature of many services, no single place of taxation rule can apply to all services. As agreed at Ottawa, consumption taxes should aim to tax services in the place where consumption takes place. Current rules broadly achieve this aim, but e-commerce has highlighted the need to adapt existing rules to ensure consistency.

3.c.2..The definition of consumption:

Under a pure consumption test, intangible services would be defined as consumed in the place where the customer actually consumes or uses the services (irrespective of the contract, payment, beneficial interest, or the location of the supplier or customer at the time of the supply). With a pure definition of consumption, tax should in principle accrue to the country in which the actual consumption takes place – for all transactions, whether business-to-business or business-to-consumer.

However, the global nature of e-commerce, combined with the mobility of present day communications, puts in question the practicability of a pure consumption test. For example, a US business contracts with a UK business customer to provide consultant services to its branches in Japan. Consumption could be said to take place in the United Kingdom where the customer's headquarters is located because the services are of benefit to the whole business, or alternatively, consumption could take place at each branch in Japan because the services are actually used there. As a second example, a French business contracts with a Canadian business to provide electronically delivered services. The staffs of the Canadian business use portable computers and receive the services all over the world. Consumption would take place in whichever country the staff member actually uses the services.

For B2B transactions there are a number of alternatives including the location of the supplier's profit-generating operations; place of contract; location of the customer;

⁴⁴⁰ ECLIP, E_Commerce Legal Issues Platform, p.86

⁴⁴¹ Taxation GIIC p.10

and location of the supplier or the recipient's business. In the latter case, the location, or "business presence", of the recipient would be an establishment to which the supply is made. This might include the headquarters, a branch, a registered office, or a seat of economic activity. Yet another approach would be to tax services where they are performed, but where they are performed in more than one place, the location of the supplier would be the deemed place of taxation. In relation to any of these approaches, specific anti-avoidance rules may be required.

For B2C transactions, there are a number of options should be identified, including the recipient's permanent address or usual place (jurisdiction) of residence; their centre of vital interests; and where he/she is a national. The supplier would need to be able to identify the location and tax status of their private customer with ease and certainty. It is unlikely, however, that a supplier would ever have sufficient information to determine the private customer's "centre of vital interests" or nationality.⁴⁴²

The place of consumption for most services provided to a business customer could be the country where that business is established. In cases where consumption occurs in a different country, to overcome avoidance opportunities an additional rule would operate to ensure that tax accrued where consumption actually took place. The place of consumption for most services to private consumers may be the country where that customer has his or her permanent address or is usually resident.⁴⁴³

3.c.3..Defining place of consumption

The place of consumption for the cross-border supply of conventional goods (e.g. a compact disk) can be based on the recipient's address for delivery. If tax is not otherwise payable then appropriate customs systems can collect tax on the importation of physical goods without unduly impeding revenue collection and the efficient delivery of products to consumers. Moreover, due diligence by the supplier and verification by revenue authorities is relatively simple.

In contrast, where products are digitally downloaded or electronically delivered via the Internet, there is no physical delivery address for the supplier to rely upon and this therefore has the potential to create difficulties for revenue authorities as well as for suppliers (e.g. corroborating the "export" of a product, and so its exemption from tax).

⁴⁴² OECD, *Consumption Tax Aspects of E-Commerce*, M00022378pdf

⁴⁴³ GIIC, *Discussion Paper on E-Commerce Taxation an Tariff Issues*, 2 Aug 2000, p.11

Services may be broadly categorised as those that are either *tangible*, where the place of consumption can be readily identified, or those that are *intangible*, where the place of consumption may be uncertain. While this categorisation is not a technical one, it helps to illustrate how, in relation to certain transactions, difficulties in determining the place of consumption can arise.

Examples of *tangible services* include services relating to specific areas of land, including buildings (estate agents, hotel accommodation, and architects); transport (including related services such as handling); and services relating to physical performance (sporting events, concerts, hairdressing services, and restaurants). Each of these services are either physically performed or take place at an identifiable location and may therefore be said to be consumed at that location. Therefore, determining the place of consumption for tangible services can often be defined as the jurisdiction where the service is actually performed.

Examples of *intangible services* include consultancy, accountancy, legal and other “intellectual” services; banking and financial transactions; advertising; transfers of copyright; provision of information; data processing; broadcasting; and telecommunications services. These services cannot readily be seen to be physically performed or to take place at a particular location and are often deemed to be consumed where the provider or customer is located. Any services capable of electronic delivery (including many of those above) are similarly intangible and therefore represent a challenge in defining a practical consumption test. Other types of intangible services will, no doubt, be developed as technology advances.⁴⁴⁴

The place of consumption principle for e-commerce is not met by the present basic rule. The solution may lie in adopting a new basic rule that taxes international services in the country in which they are consumed.

The emerging international view is that the definition of place of consumption for private consumers should be their usual place of residence. This would simplify decision making for suppliers, most of whom routinely collect this information for marketing purposes. In particular such a rule would deal with the problems of convergence where a number of services, each currently with different place of taxation rules, are provided as a single package for a single charge. Treating such a package under a single place of taxation rule would be simpler both for businesses and the Government and would

⁴⁴⁴ OECD, *Consumption Tax Aspects of E-Commerce*, p.12

ensure there is no distortion of competition caused by double taxation or unintentional non-taxation.

Business-to-business transactions

In terms of B2B transactions, the intangible services have to be treated as consumed where the recipient has located its business presence, and a Guideline should be framed in these terms. The business members of the Consumption Tax Technical Advisory Group of CFA agree with that option, which appears to them workable and well grounded in existing practices. Where there is a choice of locations, such as a headquarters in one country and a branch in another, the business presence should be considered as the establishment (for example, headquarters, registered office or branch of the business) of the recipient to which the supply is made. In certain circumstances, revenue authorities may use a different criterion to determine the actual place of consumption to ensure that the business structure or the mobility of communications is not used to avoid taxes by routing services through temporary establishments in non-tax or low-tax jurisdictions.

Business-to-consumer transactions

A Guideline based upon the jurisdiction in which the customer has his/her usual place of residence is the most practicable, albeit not the most theoretically pure, definition of "place of consumption" for B2C transactions. Where a consumer has more than one country of residence the place of consumption should be the jurisdiction in which they spend the majority of their time. The business members of the Consumption Tax TAG consider the concept of treating the customer's normal jurisdiction of residence as the place of taxation as a significant step in achieving neutrality between e-commerce transactions and conventional forms of transactions. The Technology TAG has highlighted the significant problems which are currently presented in attempting to identify the jurisdiction of a "virtual" customer. It argues that, with the major exception of digital certificates, technology is only likely to be able to determine a consumer's location in the longer term. Hence its support for leaving open the possibility of revisiting, in the longer term, the practical application of the place of consumption for B2C transactions.⁴⁴⁵

3.d..Identification of transactions

In contrast to goods that cross borders physically and can be identified easily, digitised products can be bought and sold across borders without any obvious indication of a transaction having taken place. For businesses that are required to keep books and records, and where the Government has a right of audit, this does not present obstacles. On the other hand, sales from other countries to private consumers can cause problems. It is important to find simple and effective ways in which consumption taxes can be self-assessed and collected on digitised products.

A further complication arises as developments in technology enable customers to obtain, and use, many on-line services while on the move between countries. Any changes to existing legislation will need to incorporate a correcting rule to ensure that these services are taxed in a non-distortive manner.

□ **Performance services:** at present services such as education and live entertainment are taxed where they are physically performed. The Internet brings the possibility of performer and audience being scattered around the globe rather than being gathered in one physical location. The rules need adapting so that they distinguish between services where the participants are in the same location, and those where they are remote. The former should be taxed in the country of performance with the latter taxed in the customer's country.

Location of the Consumer

With electronic commerce, a vendor can be located physically in one jurisdiction, the product or service can be stored on a computer server in a second state, the consumer can reside in a third state, and the consumer can access the information from a fourth state. Which state (or states) has the jurisdiction to tax the transaction?⁴⁴⁶

While most states will site sales of services to where the consumer uses the service - this location may not be readily identifiable by the vendor. With respect to sourcing sales of E-mail and similar services, siting the sale for purposes of sales and use tax jurisdiction is complicated by the fact that a consumer's computer may not be located in one jurisdiction but may instead be moving (especially with the increased utilization of laptop computers). Similar problems arise with wireless

⁴⁴⁵ OECD, *Consumption Tax Aspects of E-Commerce*, p.13 US

telecommunications such as cellular phones, pagers or personal communications networks. Increasingly, wireless phone systems will act as hand-held digital platforms - used for sending E-mail or faxes or connecting to the Internet. By their nature, these services involve mobile consumers who generally are not in any fixed location. Vendors may know where the billing address of their customer is, but may not know where the "use" of the service occurs.⁴⁴⁷

Furthermore, for many Web transactions, the vendor may be unaware of the state the consumer resides in (and utilizes the product or service in). Web addresses such as Consumer@aol.com do not typically identify the state of the customer's residence or commercial domicile. Difficulties may also arise in determining the jurisdiction(s) in which the taxable "use" of the property/service occurs where the property/service is downloaded at one location but is utilized by the purchaser in a number of locations in different states. This is especially problematic for electronic commerce where transactions can frequently be configured for the consumer to access software or information from a remote server (in another jurisdiction) or download the data directly onto the consumer's own computer.

Characterization of Sales

Sourcing rules may also depend on characterization of the sale. For instance, the sale of a prepaid long distance telephone card may be treated as the sale of the card itself (i.e., tangible personal property), or the sale of a service (i.e., telecommunications). If the sale of the card is treated as the sale of tangible personal property, the sale occurs at the point where the card is purchased. If the sale of the card is treated as the sale of a service, the sale occurs at the point where the telecommunication is initiated.⁴⁴⁸

2. Classification of Digitized Products

There is a view that the on-line supply of digitized products should not be treated as a supply of goods, but presumably as a supply of services. We note that this is inconsistent with the principle of neutrality, since products such as books, software, images, music, or information may also be delivered in a tangible form which would be treated as goods. In this instance, we would encourage a policy that provides that the

⁴⁴⁶ Taxation of cyberspace part.2 US

⁴⁴⁷ Taxation of cyberspace p.2. US

⁴⁴⁸ Taxation of cyberspace part.2 US

rate of taxation should be consistent regardless of the method of delivery. If digitized products are treated as services, then further guidance is needed to specify which source of supply rules for services shall govern because there are many different rules for different types of services.⁴⁴⁹

3.d.1..Distinction between Goods and Services

The cornerstone of the taxation of electronic commerce for VAT purposes is the distinction between goods and services. This issue is one that is often argued in legal and economics research. The treatment of software for VAT purposes forms the starting point for this discussion. But is that also valid for software downloaded electronically from a network?

Art. 6 para. 1 Sixth Directive states that supply of services shall mean 'any transaction which does not constitute a supply of goods within the meaning of Article 5'. Pursuant to Art. 5 para. 1 Sixth Directive supply of goods shall mean the transfer of tangible property as owner. No transfer of tangible property is involved in the electronic transfer of software.³⁶⁰ Therefore, the download of software from a network does not result in the supply of a good in accordance with Art. 5 para. 1 Sixth Directive.³⁶¹ This treatment applies to electronic commercial transactions of any kind since only electronic 'bits' of information are transferred through the Internet. In applying VAT to the transfer of digitised products there is no difference between software on the one hand and literature, video and music on the other hand. In digitised form, such products are intangible. In the context of electronic commerce the issue arises as to whether the downloading of digitised products might be treated as a supply of goods under this provision. The data of which digitised products consist are transmitted through the network(s) in the form of electronic signals. However, there is a fundamental difference to electric currents and similar phenomenon. The items mentioned in Art. 5 para. 2 Sixth Directive are intended to be consumed. The transmitted data is not. It stays in its digitised form and can be copied an unlimited number of times. Thus, the data cannot be assumed to constitute an electric current or the like.³⁶³ The downloading of digitised products therefore does not give rise to a supply of goods under the provision of Art. 5 para. 2 Sixth Directive. Thus, according to Art. 6 para. 1 Sixth Directive the downloading of digitised products from a network constitutes a supply of services.

Place of Supply v. place of consumption

The place of supply is generally the place where the goods are when the despatch or the transport begins. In order to eliminate the differences between electronic supply of services within the EU and from third countries, the OECD 430 and the EU 431 are focusing on taxation at the place of consumption. Unreasonable tax burdens will hinder the growth of the Internet, a medium with great potential for contributions to the economic health of the states and the welfare of their citizens. If the Internet is going to be a boon, it will also be a boon to the states. Any new public policy should remove obstacles to achieving the maximum economic growth possible, enable more Americans to use the Internet to take advantage of the rich resources in information, communications, and computing technologies, and create the largest possible marketplace for U.S. providers of high technology products and services.

It is assumed that European Commission staffers have gone back to the drafting table to come up with something that will please everyone. This is going to be really difficult.

The answer probably lies in technology. Systems should be developed that allow online vendors to easily handle VAT collection - in all countries - simply through plugging into an online collection system. This is the solution being sought in the US, where the Streamlined Sales Tax Project hopes to create a kind of 'plug-and-play' tax collection system for online sellers. In the US, the system has to be simple because the States are unable to compel most online vendors to collect tax. The vendors will have to do so voluntarily. To attract voluntary participants, the States must have an attractive system.

The States have already developed a legal framework under which streamlined online tax compliance will go forward. This is at least one step ahead of the Europeans. The States have not yet addressed online compliance related to digital products. However, because at least half of the States currently collect sales tax on digital products this is an issue that will have to be worked on.

State and local governments have a responsibility to create an environment that will facilitate economic growth and make available to its citizens the many benefits new technology has to offer.⁴⁴⁹ If the States are successfully in putting into place a

⁴⁴⁹ GIIC, Discussion Paper, p.11 US

⁴⁵⁰ CAYO Carol, *Straight Talk: Internet, Tax and Interstate Commerce*

streamlined system of online tax collection, and if they are able to successfully deal with the issue of digital products, the Europeans may be able to adapt these systems to collect VAT.⁴⁵¹



⁴⁵¹ BASU S, *Taxation of E-Commerce*, P.16

PART 4. EUROPEAN UNION AND TAXATION OF E-COMMERCE

Ch.1.. Taxation, Tax Harmonisation and European Union

The process of regional integration is gradually gaining importance in the world. Countries having common interests in geographically proximate areas tend to set up regional economic and commercial associations.⁴⁵² Today, according to some authors, the European Union goes gradually to a federal structure.⁴⁵³ In the history also, we can see many exertions –many also include use of power- for unification or integration of Europe. The idea of unification of West European countries advocated by many historians, philosophers, politicians and jurists from 14th century till today.⁴⁵⁴ After World War II the idea reappeared stronger than ever. After the Messina Conference which started in 1955, the original six members of the European Coal and Steel Community signed the 'Treaty Establishing European Economic Community' on 25 March 1957 in Rome⁴⁵⁵ and a new hope spread over the continent.

From the beginning it was clear to everyone that the process of integration would be gradual, it would take a long time and it would suffer periodic setbacks. Due to this perception, the integration was based on a strategy of achieving first the simplest goals, postponing to an undetermined future the projects which cover controversial matters.⁴⁵⁶

The European Union is a sui generis international organisation in connection with its targets and with its organisational structure to reach them. It is neither only an international organisation nor a federal state. It is a supranational body that has its own constitution, which has a legal identity independent of its members'. The member states' sovereignty is restricted in the areas which fall in the scope of The Union itself.⁴⁵⁷

⁴⁵² DARTAN M., The Economic Co-Operation Organisation(ECO) Reality or Utopy?, Marmara Journal of European Studies, Vol:8 No:1-2,200 p.205

⁴⁵³ ÖZCAN M., Emniyet Teşkilatının AB'ne Uyum Sürecinde Yöntem Sorunu, Turkish Journal of Police Studies, Vol:2(7-8) p.137, Ankara,2000

⁴⁵⁴ KÖKTAŞ A., Avrupa Birliğinde İşçilerin Serbest Dolaşım Hakkı, p.9, Nobel Yayınları, Ankara 1999

⁴⁵⁵ KABAALIOĞLU Haluk, Turkey and The EU: Converging or Drifting Apart? Marmara Journal of European Studies, Vol:7, No:1-2, 1999 p.109

⁴⁵⁶ VERLOREN P. And KAPTEYN P.J.G., Introduction to The Law of European Community, p.21., Gornley, 2nd Ed.1989

⁴⁵⁷ ÖZCAN M., Avrupa Birliğinde Fikri ve Sınai Haklar, p.25, Nobel Yayınları, Ankara 1999

One of the main objectives of the EC is to abolish all obstacles to the free movements of goods, capital, people and services within the Community.⁴⁵⁸ By this way and by abolition of trade barriers among the members and completion of a customs union, a common, perfectly competitive market should be possible.⁴⁵⁹ But it was also clear that differences among tax systems of the members of the Customs Union are one of the most important impediments and one of the most difficult to alleviate -because it is accepted to be directly related with the full sovereignty of the members-. In this point there were three approaches for tax harmonisation in the common market. First, the 'equalisation approach' argued that the member states should agree to a single taxation system and to single rates or a range of tax rates. Second, the competitive approach defended not to interfere with national sovereignty and leaving the tax policy to the member states. Thirdly, the differentials and co-ordination approach recommends tax policy is to be left to member states but the Community take some measures for effective coordination and for distortion of competition.⁴⁶⁰

The differences in taxation systems may hinder free movement of goods, persons, capital and services by distorting the competition. Particularly the destination principle in consumption taxes may cause protection of domestic goods against foreign-imported- goods by practising high rates of taxes to imported goods. As a result the harmonisation of taxes is the only way to prevent the impediment of free circulation in an economic union.⁴⁶¹ The EU has no Tax Administration Body, and there are very very few taxes that the community itself practices to the citizens, the right of taxation is one of the areas which the member states has the only control and full sovereignty. Raising revenue is a cherished aspect of national sovereignty. Transfer of this power to the Community is a very visible and to some alarming manifestation of diminution in national sovereignty.⁴⁶² But in addition to this by the measures taken at the Community level and by the policies accepted further and further the sovereignty of member states are being restricted day to day. Today it can be told that there has been a Community tax law different from the international tax law and tax laws of member states.⁴⁶³

⁴⁵⁸ ÖZCAN M., Avrupa Birliğinde Fikri ve Sınai Haklar, p.2, Nobel Yayınları, Ankara 1999

⁴⁵⁹ Tax Harmonization book, p.117

⁴⁶⁰ ÖZÜDOĞRU Ö.İ., Harmonisation of Direct taxation in The EU, p.4, Working Paper, 2001

⁴⁶¹ SOYDAN YALTI B., Hizmet İşlemlerinde KDV,

⁴⁶² WEATHERILL S. And BEAUMONT P., EC Law, Penguin Books, Second Ed., London 1995, p.421

⁴⁶³ SOYDAN YALTI B., Hizmet İşlemlerinde KDV,

Art 95 of the TEC states; 'no member state shall impose... on the products of other Member States...any internal taxation...excess of....similar domestic products.' Article 95 forbids internal taxation that discriminates against goods imported from other member states. However it goes no further than a rule against discrimination; it does not ensure equalisation of tax treatment between member states. Tax regimes remain different state by state, subject only to a requirement of non-discrimination.⁴⁶⁴

In general the tax systems of the member states are still dissimilar and they reflect important differences between the member states' economic and social structures and policy objectives.

The Treaty on European Union (TEU 99), signed on 7 February 1992, marked a significant step towards a more integrated Europe.⁴⁶⁵ It specifies that 'the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation' is a principal objective of the Community, and that laws in general-including tax law- should be approximated to the extent necessary for the 'functioning of the common market.' (TEU 100)⁴⁶⁶ The general aim of tax harmonisation is to be fiscal neutrality defined as equal treatment for domestic production and imports from member countries. Issues about optimum taxation are not considered. The complexity of the problem and the widely held principle of 'no taxation without representation', which makes tax sovereignty one of the fundamental components of national sovereignty-which is accepted' as a basic component of democracy according to almost all constitutions-⁴⁶⁷, meant that rather little could be achieved, and at a slow pace.⁴⁶⁸

From 1969, six Directives set up VAT as the common sales tax of the Community. Tax harmonisation at the going phase of integration in the EC meant adopting only a common structure, but no attempt was made to impose on the members a common VAT rate. Acting on the axiom that fundamental changes in the tax field impinge on the prerogative of national parliaments, the Community based tax harmonisation on the operational principle of structural uniformity first and rate equalisation later. The sixth Directive of 1977, on a uniform assessment for VAT, aimed at closer structural harmonisation by introducing a common list of taxable activities and

⁴⁶⁴ WEATHERILL S. and BEAUMONT P., EC Law, p.396, Penguin Books, Second Ed., London 1995

⁴⁶⁵ CEBEÇİ M., İZCİ R., The European Union on the Eve of 21st Century, Marmara Journal of European Studies, Vol:6, No:2 1998, p.73

⁴⁶⁶ Tax Harmonisation book p.122

⁴⁶⁷ GÖZÜBÜYÜK Ş., Anayasa Hukuku, Turhan Kitabevi, 8th Ed., Ankara 1999, p.69

⁴⁶⁸ Tax Harmonisation, p.122

exemptions. It also specified a common tax threshold, a lower limit of exempted transactions.⁴⁶⁹

As a conclusion, today every member state has the sovereignty of right of taxation and the Community itself can only regulate the main framework about tax issues. Taxation is increasingly recognised as being a crucial factor for growth and job creation in Europe. For this reason Member States are to be called for further co-ordination on taxation.⁴⁷⁰ Also it is clear that a fundamental harmonisation of tax laws is needed to deal with the increasingly integrated economy of e-commerce.⁴⁷¹ Efforts of Community bodies on the taxation of electronic commerce must also be evaluated within this perspective.

Ch.2.. European Union's Work on Electronic Commerce

2.a.. General

The European Union is by far the most active of all international organizations in developing directives and policies impacting the information economy. Their directives shape the economic climate and actions of the industrialized nations of Europe. The professional staff of the Commission, based in Brussels has been very aggressive in identifying and acting on policy issues for the Information Society. The EC administers, through various directorates general, funding for IT research and development. Several Commission directorates general (DG) have jurisdiction over issues impacting the information economy and the Internet. DG XV is concerned with the internal market of Europe and financial services issues. This DG is managing the development of Europe single currency policies. DG XXI handles customs and indirect taxation issues (i.e. a duty free internet environment would concern them).⁴⁷²

The European Commission seeks to promote electronic commerce with all means available. The Europe Union has an attractive starting position, with its internal market of 370 million people, one single currency and the future expansion of the Union.⁴⁷³

⁴⁶⁹ Tax Harmonisation, p.130

⁴⁷⁰ MONTI Mario, *EMU Taxation and Competitiveness*, Kangaroo Group Conference, 27 Nov 1998, London

⁴⁷¹ SOMMERS L.Robert. *The Future of Internet Taxation*, The San Francisco Examiner Newspaper, November 14, 1999

⁴⁷² James A. Johnson, *Report on International Organizations*, March, 1997, www.nii.nist.gov/pbs/intl_org.html.

⁴⁷³ Timmers Paul, European Commission, Information Society Directorate General, *E-Commerce: A Challenge for Europe*, www.ispo.cec.be/ecommerce/answers/challenge.html

Furthermore policy papers have been adopted about taxation (especially VAT, although these consider principles only until now). In addition agreement exists that there should be no customs on services provided via the Internet (although the international discussion has not yet been concluded about the exact definition of a service – does this also include the online delivery of a book in digital form?).

2.b.. On Taxation Issues

Commercial use of the Internet continues to expand.⁴⁷⁴ By the effect of it, over the last two decades, the interdependence of the markets and production in different countries has gained momentum. A number of forces drive this phenomenon of globalisation. Globalisation is an opportunity to seize. It holds out new opportunities for the entire global community. But it is also true that technological progress and globalisation exert pressure, on enterprises and on countries, to maintain and improve their competitive position.⁴⁷⁵ Information technologies are one of the main and most important factors of the new era.⁴⁷⁶

Insofar as taxation is concerned, the changing environment means that countries must fight to continue to make their tax systems competitive. Globalisation and e-commerce in particular have highlighted deficiencies in existing tax systems world-wide and forced administrations to accept that many of their problems can only be resolved by closer co-operation.⁴⁷⁷

The European Community's responsible bodies are eager on electronic commerce related taxation issues. They are actively participating with other states or other international organisations about the subject. At the first hand we want to name the publicised documents which lay foundation about the legal structure of the issue. Then we will examine how these documents shape the taxing of European Union of electronic commerce. The official documents on taxation of electronic commerce are namely;

1-) European Commission, Directorate General XXI, Working paper on Indirect Taxes and e-commerce, Brussels, 8 June 1999

⁴⁷⁴ RICCI Jonathane, *E-Commerce and Non-Resident Aliens*, J.L. & TECH. 7 (Fall 1999) <<http://www.richmond.edu/jolt/v6i2/article2.html>>.

⁴⁷⁵ ABEELE V. Michel, *Taxes Without Borders*, World Tax Conference, Tampa, USA. ,27 February, 2000, europa.eu.int/ecommerce/speeches/vda_tampa_en.htm

⁴⁷⁶ İLYASOĞLU E., *Türk Bilgi Teknolojisi ve Gümrük Birliği*, İş Bankası Yayınları, Temmuz 1997 İstanbul, p.7

⁴⁷⁷ BOLKESTEIN F., *Taxation Policy in The European Union*, Inst. Of European Affairs, Dublin, Ireland, 29 May 2001, europa.eu.int/ispo/ecommerce/speeches/29may2001iea_en.htm

2-) European Commission's Communication to the Council of Ministers, the European Parliament and to the Economic and Social Committee on Electronic Commerce and Indirect Taxation.

3-) European Commission DG XXI/98/0359 Working Party No I — Interim report on the implications of electronic commerce for VAT and Customs

4-) European Commission Proposal of June 7, 2000 for a 'Regulation amending Regulation (218/92/EEC) on administrative co-operation in the field of indirect taxation (VAT)'

5-) European Commission Proposal of June 7, 2000 for a 'Directive amending Directive 77/388/EEC as regard the value added tax arrangements applicable to certain services supplied by electronic means.'

6-) European Commission Proposal for a Directive of November 20, 2000 amending Directive 77/388/EEC with a view to simplifying, modernising and harmonising the conditions laid down for invoicing in respect of value added tax.'

7-) European Commission Communication of February 9, 2001: 'Electronic Commerce and Financial Services'⁴⁷⁸

In its Communication "A European Initiative in Electronic Commerce" COM(97)157 the Commission stressed the need to ensure a clear and neutral tax environment and the importance of implementing tax rules which avoid market distortion: "*in order to allow electronic commerce to develop, it is vital for tax systems to provide legal certainty (so that tax obligations are clear, transparent and predictable) and tax neutrality (so that there is no extra burden on these new activities as compared to more traditional commerce)*". It also stated that VAT, as opposed to any new form of tax, is appropriate to electronic commerce, just as it is to more traditional ways of conducting business.⁴⁷⁹

Paul Timmers from Information Society Directorate General of EU commission makes a self-evaluation: 'it is questionable whether action is radical and fast enough. The development of the digital economy, and correspondingly of international competition, are proceeding at the pace of a high-speed train, while new legislation as well as industry-wide acceptance of codes of conducts takes time. Probably we will have to wait long for a world-wide legislative framework. Internet entrepreneurs move fast ahead and build on the basis of their 'first-comer advantage' their new imperiums,

⁴⁷⁸ Dont Panic p.70

⁴⁷⁹ Commissions Communication on Indirect Taxes and E-Commerce

while the legislative and self-regulatory framework evolves only gradually. Success stories are well-known from the online book world and from the travel world.

In Europe in a very short time unmistakably much has happened in electronic commerce. Businesses and consumers have reacted with a bout of enthusiasm and political backup is increasing steadily. However, despite these good signs....the clock is ticking away.⁴⁸⁰

2.c.. US-EC vision of the development of electronic commerce

After a slow start, electronic commerce (e-commerce) is taking off in Europe. People are going on-line at unprecedented rates and on-line shops are popping up left and right. *A business card without an e-mail address is becoming rarity.* Nevertheless, there are still a number of barriers preventing many small and medium sized enterprises (SMEs) from going on-line and causing consumers to be wary of shopping on line. *The law is one of them.*⁴⁸¹

Many existing SMEs are confused by e-commerce-related law and so are reluctant to go on-line. They are often established companies that have been doing business for years, if not generations. But their business has always been local. Suppliers are local. Customers are local. And, of course, the law is local. They know that when they put their business on the web, suppliers and customers could come from anywhere in the world – and that translates into a whole new set of laws to deal with.⁴⁸²

The Internet was originally set up and controlled by the US Department of Defence and developed as a tool for communication and exchange of information within the academic and research communities. In the last few years, due to the increasing availability and affordability of personal computers and telecommunication services, its use has become global and there has been an explosion in the level of Internet traffic. *Although the Internet is at present primarily a communication tool there is much evidence that the business community is increasingly aware of its potential use as a marketing and sales medium.* At the moment, there is a considerable level of advertising of products and services but little evidence of large-scale commerce being conducted over the networks.

However, with the ever increasing sophistication of the networks, and in particular with regard to increasing transmission speeds and the development of secure

⁴⁸⁰ Timmers Paul , European Commission, Information Society Directorate General

⁴⁸¹ Dont panic p.3

⁴⁸² Dont panic p.3

means of payment, it can be predicted that over the next year or so there will be a rapid expansion of sales of goods and services via this medium.

The United States Treasury policy statements early in 1997 stimulated the high profile debate that has been taking place, both within the EU and at international level regarding these developments. *Broadly speaking, it recommended allowing e-commerce to develop, as far as possible, without regulation and without any additional taxes.* In July 1997, the US President announced a formal initiative and at the same time released a report, "A Framework for Global Electronic Commerce". All this culminated in an EU-US Summit, on 5 December 1997, at which a joint statement on the subject was agreed and issued. *The concerns of EC indirect tax authorities were voiced during this debate and the drafting of the joint statement.* It was made clear that, aside from revenue considerations, it would be essential to be able to apply VAT to trade over the networks in order to avoid distortion of competition with similar conventionally traded products. Anticipating these developments, *Commission raised these issues at a meeting of the Directors General, Customs and Indirect Taxes, which took place on 26 March 1997 and was the starting point for Community action to determine the future indirect tax treatment of e-commerce.* All participants were of the opinion that the potential impact of e-commerce on Customs and VAT would be such as to justify thorough analysis as a matter of priority. Accordingly, Member States pledged support for a review of Customs and VAT legislation in the light of these developments and where necessary to propose relevant modifications. In June 1997, the Commission started in the N° 1 Working Group to study these problems.

There has also been considerable activity in the OECD in a number of fields concerning development of the networks and e-commerce. Within the Committee on Fiscal Affairs, the Special Sessions on Consumption Taxes has been considering the potential problems for indirect tax systems arising from e-commerce. A sub-group, starting work in July 1996, made a study of potential distortions of competition which could arise as a result of different tax treatment of transactions between OECD member countries. The sub-group is to continue with its work with a view to preparing the ground and making proposals for the framework guidelines to be put to ministers at a meeting in Ottawa in October 1998. *The Commission and a number of EC Member States are*

represented on this sub-group which should avoid any duplication of work in preparation for the Ottawa Conference.⁴⁸³

Ch.3. Legal Analysis

Regulation is not an end in itself. This has already been recognised in the Commission's Communication on electronic commerce, which proposed the principle of "*no regulation for regulation's sake*".

Regulatory uncertainty resulting from the scope of current definitions; the way they are applied or whether they fit changing market structures or service characteristics could constitute an important barrier to investment by market players.

Furthermore, within Member States barriers could result if similar services were regulated differently, for example on the basis of the platform over which they are delivered.

In other cases, the characteristics of services in the future may mean that they straddle more than one regulatory area on the basis of current definitions. This may result in a disproportionate regulatory burden on certain services.

The process of obtaining regulatory clearance in all Member States and potentially from different regulatory bodies for a particular package of services may create substantial overheads for those wanting to operate on a pan-European basis.

If Europe can embrace these changes by creating an environment which supports rather than holds back the process of change we will have created a powerful motor for job creation and growth, increasing consumer choice and promoting cultural diversity. If Europe fails to do so, or fails to do so rapidly enough, there are real risks that our businesses and citizens will be left to travel in the slow lane of an information revolution which is being embraced by businesses, users and by Governments around the World.

3.a..Guiding principles

The Commission's approach to the question of taxation of e-commerce has been motivated by two factors – *protection of tax revenue* and *ensuring that the development of e-commerce in the E.U. was not hindered by a distortive or disadvantageous tax*

⁴⁸³ EU COMMISSION XXI/98/0359 Working Party No I — Interim report on the implications of electronic commerce for VAT and Customs

regime.⁴⁸⁴ Finance ministers in ECOFIN agreed on the underlying principles. These guidelines continue to form the basis of the Commission's work on taxation of e-commerce. The key points (for the purposes of this note) provide that:

-no new or additional taxes need to be considered at this stage and that, in the field of indirect taxes, all efforts should be concentrated on adapting existing taxes – specifically VAT – to cope with the developments of e-commerce;

-a supply that results in a product being placed at the disposal of the recipient in digital form via an electronic network is to be treated, for VAT purposes, as a supply of services;

-services supplied for consumption within the E.U. should be taxed within the E.U. and those supplied for consumption outside the E.U. should not be subject to E.U. VAT but deduction should be allowed on related inputs.⁴⁸⁵

The tax system should also provide legal certainty, simplicity and neutrality. The Commission set up a number of guidelines for realization of this objective in its Communication on Indirect Taxes and Electronic Commerce. We cite them here because of their importance;

Guideline 1: No new taxes: The first guideline has been formulated to reflect the basic concept that existing taxes should apply to electronic commerce: 1. In the field of indirect taxation all efforts should to be concentrated on adapting existing taxes and more specifically VAT to the developments of e-commerce. No new or additional taxes are therefore to be considered.

Guideline 2: Electronic transmissions as services: It is the policy of the EU to consider products ordered and delivered on networks to be services. E.U. VAT legislation makes a basic distinction between the supply of goods and the supply of services. All types of electronic transmissions and all intangible products delivered by such means are deemed, for the purposes of EU VAT, to be services.

Guideline 3: Ensuring neutrality: The E.U. VAT system should ensure that:

-Services, whether supplied via e-commerce or otherwise, which are supplied for consumption within the E.U. are taxed within the E.U., whatever their origin.

-Such services, supplied by EU operators for consumption outside the E.U. are not subject to VAT in the E.U. but VAT on related inputs is eligible for deduction. The above guideline does not prejudice the rules that will be applied within the E.U.

⁴⁸⁴ Commission's Working Paper on Indirect Taxes and Electronic Commerce, Brussels, 8 June 1999

⁴⁸⁵ COM (98) 374 final

Overall, this guideline represents a significant change compared to the present situation. *It would mean that all services delivered on-line from non-EU sources to private individuals in the EU would be subject to VAT and that all such services exported from the EU to other countries would be free of VAT.* This would ensure tax neutrality between EU and non-EU supplies. To preserve tax neutrality between offline and online deliveries, it would mean that, unlike now, services delivered by traditional means, such as telephone, or fax, from non-EU sources to private individuals in the EU, would also be subjected to VAT.

Guideline 4: Making compliance easy: The credibility of any system of taxation rests on its practicality, and the feasibility of its implementation. There should be certainty about the rules and compliance should be made as simple as possible to avoid unnecessary burdens on business. Also there must be assurance, both from the point of view of the businesses concerned and the tax authorities, that the tax can be controlled and collected efficiently and effectively. The global nature of these commercial activities has to be taken into account and international consensus and co-operation should be sought to create the right tools to make compliance easy.

Guideline 5: Ensuring Control and enforcement: Rules should be restricted to a minimum and disproportionate obligations avoided in order to allow e-commerce to flourish. However, at the same time, there must be assurances that the tax can be controlled in an effective way. The tax system and its control tools must ensure that taxation is enforceable on supplies of services received within the E.U., via e-commerce, by both businesses and private individuals.

Guideline 6: Facilitating tax administration: If businesses are to have confidence in a tax system it must be capable of being applied fairly and with certainty and in a manner which allows the full benefits of e-commerce to be realised. By the same token, it is essential to ensure that, in the field of e-commerce, compliance burdens are no more onerous for EU operators than they are for non-EU operators. Paperless electronic invoicing will be a characteristic of electronic commerce and must be authorised for VAT purposes for transactions within the E.U. Subject to uniform EC conditions, fiscal administrations should provide for operators, participating in e-commerce to discharge their fiscal obligations by means of electronic VAT declarations and accounting.⁴⁸⁶

⁴⁸⁶ Commission Communication on Indirect Taxes and E-Commerce p.3-6

3.b..Main objectives

The networks are opening up opportunities for individuals to by-pass the more traditional ways of doing business around which tax schemes are currently constructed. *It is therefore necessary for tax authorities to understand fully how the new environment will develop both technically and organisationally.* Changes will be necessary to adapt the existing systems and procedures to prevent loss of revenue and to ensure that there is no discrimination between businesses using the new technology as opposed to those continuing to trade conventionally. What makes this difficult is the lack of certainty over the way in which the networks will evolve in the field of commerce. In particular the nature of the regulatory framework is not yet clear. However, it is of paramount importance for tax authorities to intervene at the earliest opportunity, to influence their structure and content, so that they can be accessed and used in bringing tax to account in the appropriate place and to ensure compliance. Of course it is necessary to state broad objectives for a tax regime to be applicable to e-commerce and at present it is assumed that the principles of the VAT system will be applicable, the mechanism being adjusted as necessary. However, at this stage it would be premature to decide on any particular legislative scheme without having a clear view of how it can be managed in practice. The purpose of the study to date has been to investigate the structure and find out as much as possible about the way in which e-commerce will develop. Existing VAT principles and administrative techniques are being examined to see the extent to which they could be applied or adapted to suit the new circumstances.⁴⁸⁷

There are three main criteria for the realisation of the objectives

Consumption - VAT is a tax on consumption and there is a broad consensus of opinion that this is the principle that should be applied to transactions which take place over the electronic networks in what can be described as a global, borderless, virtual marketplace. The problems of taxing such supplies are therefore also global and so should be the solutions. *The immediate task for the EU is to find a suitable definition of consumption and to be able to apply it to all supplies that are deemed to be "consumed" within the territory of the Member States, including those made on-line via the networks.* The problems are not so pressing with the types of supply which are simply arranged over the networks but are delivered in a tangible form as goods – it is possible to deal with these using traditional techniques and controls. The main difficulties are in the field

⁴⁸⁷ XXI/98/0359 Working Party No I – COMMISSION – Interim report on the implications of electronic commerce for VAT and Customs

of on-line services and "virtual" goods, such as music video and software, which, being delivered digitally, are intangible and not susceptible to physical controls. Nevertheless, it was agreed that the working groups needed to consider all aspects of e-commerce and to look at its interaction with traditional trading methods.

Neutrality - Tax should accrue at the final stage of consumption and not be a burden at the stage of production or distribution.

Distortion - To avoid distortion, the tax system should, in theory, ensure that a purchaser of a supply in a particular country would pay the same tax whether he purchases his supply from a domestic source or from a supplier in another country. In practice, because of lack of rate harmonisation, under the existing VAT system this is not always the case. However, where e-commerce is concerned, it will be necessary to ensure that there is no difference between the tax treatment of a supply made using that medium compared with the same supply effected by conventional means.⁴⁸⁸

3.c.. The problem with e-commerce

Due to limitations of available technology, providers of services have until recently made most of their supplies to customers in their own country. In those circumstances a simple place of supply rule was all that was necessary to define the place of taxation of such supplies. However the situation is rapidly being transformed by the developments in communications technology such as the Internet. This has created the potential for large scale international commercial activity with the possibility that suppliers in any country can provide goods and services to customers in any other country.

*Clearly with the advent of e-commerce, the relatively small amount of distortion which currently exists, due to the non-taxation of supplies from non-EU countries for EU consumption by private persons, is likely to become a serious problem unless a satisfactory way of taxing such transaction is found.*⁴⁸⁹

A more radical argument is that; 'Unilateral national measures are no longer acceptable in times of electronic commerce, all Member States' option in the 6th VAT Directive should be replaced by binding uniform rules. It is contrary to the idea of a Single Market that each Member State applies VAT law differently. Each deviation from

⁴⁸⁸ XXI/98/0359 Working Party No I – COMMISSION – Interim report on the implications of electronic commerce for VAT and Customs

⁴⁸⁹ XXI/98/0359 Working Party No I – COMMISSION – Interim report on the implications of electronic commerce for VAT and Customs

a “common” legal environment increases compliance cost and renders trade more difficult. Even if it was necessary to find some compromise solutions when the 6th Directive was introduced, because tax administrations and taxpayers would not have been able to handle too many changes at once, this argument is no longer valid. Member States had more than twenty years to recognise European Law and to adapt their differing legal systems.⁴⁹⁰

3.c.1..Direct Taxation

It is unlikely that e-commerce will have any significant impact on direct taxation (e.g. income tax, corporation tax and taxes on profit) in practice.

The fundamental beauty of the Internet, from the perspective of those who wish to minimise their tax administration, is the ability to perform transactions at a distance. Selling electronically is an obvious opportunity for a business to either reduce or avoid a tax footprint outside the country where it is resident. A business will still be liable to tax where it is resident, but it does not necessarily have to have a taxable presence elsewhere to meet its commercial objectives.

Web sites and servers through which sales are made cannot constitute a taxable presence in another country. A web site alone is not a fixed place of business and so does not create a taxable presence in another jurisdiction. Only if the business to which the web site belongs also owns or rents the server, and if the activity carried out via the web site is not within the normal exclusion for preparatory or auxiliary activities, will a taxable presence exist. In this instance, using an ISP to host a site allows a company to avoid having a taxable presence in any other country.⁴⁹¹

3c.2..Indirect Taxation

There are however important considerations for indirect taxation (e.g. Value Added Tax or sales tax) such as when different rates of tax apply to goods and to services. A book (a product) may attract one rate of tax, but in digital form be considered a service by the tax authorities and thus attract a different rate of tax. It should be noted that the EU recognises digitally delivered products such as software, digital music, digital books, etc as services.⁴⁹²

⁴⁹⁰ KORF Ralph, *Six Thoughts on the VAT Treatment of E-Commerce*, PWHCoopers, Munich

⁴⁹¹ Don't Panic Do E-Commerce

VAT(Value Added Tax)

The Internet enables companies to reach customers without regard for national boundaries. That said, cross-border sales must nevertheless comply with specific indirect taxation rules like Value Added Tax (VAT) and withholding taxes. Payment of VAT is determined based on what, where and to whom goods and services are sold. The rules within the European Internal Market differ for goods and services.

VAT on Goods

The VAT liability on supply of goods is determined by the physical movement of goods when a sale takes place and by the status of the customer. The way goods are taxed in respect of VAT is not affected by the growth of the Internet. The existing VAT system applies to goods purchased electronically and then delivered by traditional means.⁴⁹³

VAT on Services

The Internet is not only an efficient order management medium, but also a means of delivering a product itself. Customers can conveniently download any form of software such as digitised music or games, or other intellectual property such as training material or consultants' advice. Such products are, from the perspective of EU VAT legislation, classified as supplies of services and so taxed as services. Moreover the EU mail order rules regarding turnover thresholds do not apply.

The current VAT rules for services do not adequately address the supply of services delivered on-line by digital means, notably in the case of services traded between EU and non-EU countries. This is because services delivered on-line by digital means were simply not envisaged at the time the current VAT legislation was established.⁴⁹⁴ At the time of writing, electronically delivered services originating within the EU are always subject to VAT irrespective of the place of consumption, whilst those from outside the EU are not subject to VAT even when delivered within the EU. This situation has the potential to constitute a major distortion of competition and to place EU

⁴⁹²SCHULZE Corinna, *Don't Panic Do E-Commerce* Published by the European Commission's Electronic Commerce Team (Information Society Directorate General)

⁴⁹³ SCHULZE Corinna, *Don't Panic Do E-Commerce*, p.58, Published by the European Commission's Electronic Commerce Team (Information Society Directorate General)

⁴⁹⁴ BOLKESTEIN F., *A Changing Approach to Taxation With the Development of E-Commerce*, Netherlands The Hague, 14th September 2000

service providers at a disadvantage in relation to non-EU service providers. However, this could soon change.⁴⁹⁵

The European Commission has 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 objective of the proposal is to create a fair market for the taxation of digital e-commerce in accordance with the principles agreed at the 1998 OECD Ministerial Conference. A basic principle of the EU VAT system is that no new or additional taxes are needed for e-commerce. Existing taxes should be adapted so that they can apply to e-commerce.

The proposal mainly concerns the supply, over electronic networks (i.e. digital delivery via the Internet), of software and computer services generally, as well as information and cultural, artistic, sporting, scientific, educational, entertainment or similar services. But some evaluates this is a negative attitude. Kenneth Dam says: 'Unilateral proposals such as the EU's may encourage others to take unilateral measures, rather than waiting for the global consensus that can be developed through a more deliberative and inclusive process.'⁴⁹⁶

The proposal will ensure that when these services are supplied for consumption within the European Union, they are subject to EU VAT, and that when these services are supplied for consumption outside the EU, they are exempt from VAT. The proposal also contains a number of facilitation and simplification measures aimed at easing the compliance burden on business.

Non-EU operators would only have to register for VAT purposes where they undertake business-to-consumer transactions (a different regime applies to business-to-business). Where their annual sales to consumers in the EU exceed a minimum turnover threshold of 100,000 Euro, non-EU operators would be required to register for VAT purposes, but only in a single Member State (they could choose any Member State where they supplied services). They would then charge VAT at the rate applicable in the Member State they have chosen and only have to deal with a single tax administration within the EU.⁴⁹⁷

⁴⁹⁵ SCHULZE Corinna, *Don't Panic Do E-Commerce*, Published by the European Commission's Electronic Commerce Team (Information Society Directorate General)

⁴⁹⁶ Reuters News, February 12, 2002, www.reuters.com

⁴⁹⁷ SCHULZE Corinna, *Don't Panic Do E-Commerce*, Published by the European Commission's Electronic Commerce Team (Information Society Directorate General)

There are also contrary ideas for VAT treatment of electronic made supplies; a citation expresses worries about the subject. 'The VAT treatment of electronically made supplies as services leads to unnecessary difficulties already when determining the place of supply and should be reconsidered critically. The treatment e.g. of the supply of software as supply of goods is not excluded by the 6th Directive, as is evidenced by the examples in Art. 5 par. 2. The determination of the place of supply of goods is far easier than that of services. Only with regard to Distance selling the qualification of the customer does play a role, whereas it does quite often regarding services. The practical problems of tax collection are the same in both cases, but at least the theoretical determination of the place of supply is easier if electronic supplies are seen as supplies of goods.'⁴⁹⁸

2.a.. Place of supply

Place of supply rules determine where different categories of services are deemed to be taxed. The existing rules contained in Article 9 of the Sixth Directive are based on a number of different criteria. - place of supplier's or customer's establishment, place of performance, or of use and enjoyment, etc. – are all concepts used, in effect, to determine the place of "consumption" of services.

In the past, there has been little demand from EC private persons for supplies of services from non-EU countries which is why, under the existing rules; there is little or no provision for taxing supplies of such services. However, as we have recently seen in connection with telecommunication services, advances in technology have led to the globalisation of the market enormously increasing domestic consumption of services from sources outside the Community. New rules have been needed to complement the existing place of establishment rule in an attempt to ensure that all such services are taxed in the EC where they are enjoyed or used. However there is little evidence that effective control is capable of being exercised over supplies to private individuals under this regime. Similar, but more serious, problems could be encountered in the field of e-commerce, which is likely to cover a wide range of product, and for that reason much of the debate in the working groups has been focused on the place of supply rules and

⁴⁹⁸ KORF Ralph, *Six Thoughts on the VAT Treatment of E-Commerce*, PWHCoopers, Munich

relevant aspects of Article 9 which do not always ensure taxation at the place of consumption.⁴⁹⁹

2.b.. Possible consumption criteria for e-commerce

There are a number of possibilities, depending on the characteristics of the supplies, to deem where "consumption" takes place.

Criteria:

1. The territory of the country of establishment or permanent residence of the customer
2. The territory within which the performance of the services takes place
3. The territory within which the customer benefits from or enjoys the services
4. The territory of the country to which the invoice is sent
5. The territory of the country from which the invoice is sent

This list is not exhaustive; other criteria can be envisaged and some others may emerge from the networks themselves as the frameworks are developed.

At present there is no obvious choice because of the uncertainty which exists over the availability of means of control of the e-commerce networks.

Up to now, for international services, it has proved more practical to designate the place of supply (consumption) either as being in the country where the service is enjoyed or used, or where the benefit is received by the customer. For the generality of services this could be achieved by designating the place of supply by reference to the establishment or fixed abode of the customer. However, it is not feasible to propose any solution to the problem of taxing services without also considering where and by whom the tax should be accounted for to the fiscal authorities and whether, in practice, they will have the necessary tools to secure compliance.⁵⁰⁰

Some jurists stress an additional difficulty in determination of place of consumption. Ralph Korf argues that 'In determining the place of consumption, a logical rather than a physical place needs to be established, this requires legal fictions or assumptions to which proof of the contrary is not admitted. It is (at least theoretically) possible to establish the physical place where a good is consumed. This is not possible regarding services. The "place of consumption" is a scientific construct which cannot be

⁴⁹⁹ EU COMMISSION XXI/98/0359 Working Party No I - Interim report on the implications of electronic commerce for VAT and Customs

⁵⁰⁰ EU COMMISSION XXI/98/0359 Working Party No I- Interim report on the implications of electronic commerce for VAT and Customs

measured by facts. It might be possible, albeit difficult; to determine where the customer is at the moment he receives the supply. That place, however, cannot always be used as a place of taxation because it depends on pure haphazard. Therefore, criteria need to be established according to which a certain place is deemed to be the place of consumption, regardless of whether this the place of actual consumption or not.⁵⁰¹

2.c.. Taxable person

Under the existing VAT system there are two alternatives for bringing tax to account on supplies from abroad, the first being to require the supplier of the services to account for the tax to the country of supply, either directly or through a representative. The second is to require tax to be accounted for to the authorities by the recipient of the supply. The latter is possible where the recipient is a taxable person but self-assessment is hardly feasible where customers are private individuals. It is also predicated on knowing the tax status of the customer. This will not necessarily be the case in the world of e-commerce.

Therefore, serious doubt arise as to its practicability for traders and whether it would be possible to control and enforce in view of the potential difficulties of locating the parties involved.

For transactions with private persons, it has been suggested that one fiscal representative could be appointed for all the Community trading activities of a non-EU trader. This fiscal representative could declare the tax to any of the Member States, where activities take place, according to the rates in those countries. However, at present, the concept of fiscal representation is not implemented everywhere. The use of a single fiscal representative for all EU activities would be a more favourable scheme than the current telecommunications scheme where several fiscal representatives may be needed.. More work need to be done to test whether this mechanism would be a suitable tool for use in the dynamic world of e-commerce, in particular where non-EU traders are concerned.

The systems of Internet Service Providers (ISP's), and the settlement services provided by financial institutions (e.g. possibility of withholding tax) are also being

⁵⁰¹ KORF Ralph, Six Thoughts on the VAT Treatment of E-Commerce, PWHCoopers, Munich.

looked at to see if and to what extent they could provide solutions to the problems of collecting tax on e-commerce transactions.

It is clear that current VAT legislation is not necessarily properly equipped to cope with the new e-commerce environment and it is likely that changes to legislation will be necessary. The structures and protocols that will make large scale trading over the networks an economic proposition are still in course of development and need to be carefully observed. Tax authorities need to make their voice heard during that process to ensure that the systems will provide sufficient information and access to enable VAT to operate effectively in the new environment.⁵⁰²

Ch.4.. Legislative Framework

4.a.. Existing provisions

At the outset, it is necessary to consider what is the effect of the current provisions contained in the existing Community legislation. The basic rule is set out in Article 9.1 of the 6 th VAT Directive and applies where no other provisions are made elsewhere in Article 9. It was enacted at a time when there was a natural supposition of direct personal contact between the supplier of the service and the customer. Accordingly, it establishes the place of supply as the place where the supplier is located.

If this measure is taken in isolation, the result would be that, unless otherwise provided, where the supplier is based outside the E.U., no VAT is payable on services supplied to customers within the E.U. Operators registered for VAT within the E.U. are however required by Article 9.1 to charge VAT at the effective rate in their Member State to customers outside the E.U. In the absence of other provisions, this would have the potential to constitute a major distortion of competition and place E.U. service providers at a competitive disadvantage in relation to non-E.U. suppliers. This is currently the case with arbitration services, subscriptions to broadcasting services and Internet related services such as website design and website hosting (more generally, any services not referred to in Article 9.2 or in Article 28b, (C), (D), (E) and (F). The result is that VAT registered operators established in another Member State or outside the E.U. must claim this tax back under the terms of the 8 th or 13 th Directive. (There is at the very least some anecdotal evidence that this has been a contributory factor in the

⁵⁰² EU COMMISSION XXI/98/0359 Working Party No I- Interim report on the implications of electronic commerce for VAT and Customs

location of web hosting facilities outside the fiscal territory of the Community.) The main group of specific exceptions to Article 9.1 (which continues to apply where no other rule is specified) are contained in Articles 9.2 and 9.3 and provide that such services are taxed where they are actually consumed. As such, they go some way towards achieving the underlying objectives (particularly as regards taxation in the jurisdiction of consumption) and should not be changed unless the developments associated with e-commerce warrant it.

For most of the services listed in 9.2.a, b and c, electronic transmission either does not arise or can be considered as simply a method of delivery which does not change their essential nature. Certain of the activities which are listed in the first indent of 9.2.c need however to be reconsidered in the light of their capacity to be delivered to paying customers electronically. This may result in both the time and place of actual consumption being different from the time and place of performance.

Although in many instances they will be aimed at private consumers (and could continue to be taxed at the place where they are physically carried out), it will be necessary to ensure that their increased possibility of electronic delivery – whether to taxable persons or otherwise – does not give rise to the concerns listed at the outset. The traditional interpretation of the terms used – “cultural”, “educational” or “entertainment” may need to be reconsidered. What for instance is the difference between “education” and “the supply of information” when these are provided electronically?

The aim of Article 9.2.e is to tax the services listed at the place where the service is received – using the (consecutive) test(s) of where a business is established or has a fixed establishment or permanent establishment or usual residence. As such, it offers a checklist to establish a place of consumption and a list of activities to be taxed on the basis that they are consumed at that place. Although extending this list may appear to be one simple and direct method of ensuring that it covers what we wish to see taxed at the place of consumption, this approach carries the risk of needing to be revised every time a new type of service is presented or every time technology yields a new way of delivering or presenting services. Furthermore, the continued phenomenon of convergence in both technologies and services is likely to mean that the terms and definitions valid today will become increasingly questionable. There are sound reasons therefore for saying that the “list” approach is fundamentally flawed and should be replaced by some more general measure.

Any changes needed in Article 9 to achieve the underlying objectives should entail both a simplification in the overall approach and be sufficiently robust to meet the possibility of new forms of international services emerging or of technological advances which effect the delivery and accessibility of existing services.⁵⁰³

4.b.. Background to the Proposal

The Commission's Taxation and Customs Union Directorate General issued a Working Paper in June of 1999 setting out some specific options for implementing these principles within the framework of the VAT system and outlining how legislative changes might be approached.

Under the current provisions, unless specifically provided, where a supplier of services is based outside the EU, no VAT would be payable on services supplied to customers within the EU. Although the reverse charge mechanism (which is a form of self assessment for a business acquiring services) will ensure the correct taxation of most business-to-business transactions, the existing provisions do not comprehensively take account of the full range of services which can be delivered electronically today. Given that services and intangibles form an ever increasing part of international trade, this should be rectified. Furthermore, the existing rules do not ensure that electronically delivered services can, in all cases, be exported free of charge and that a sufficient legal base exists for charging VAT on services supplied to EU private consumers by foreign operators. These have the potential to constitute a major distortion of competition and to place EU service providers at a competitive disadvantage in relation to non-EU suppliers.

This is clearly an untenable situation and its rectification is an immediate objective of the current proposal. The extensive consultations undertaken by the Commission have confirmed the view that the modifications needed should be based as closely as possible on the operation of the current VAT system. What is being proposed therefore is predicated on the continued use of the reverse charge system for business-to-business transactions linked to the imposition of a registration obligation on operators supplying to EU non-taxable persons is the preferred option.

Transactions between businesses will be taxed under the reverse charge procedures. For this purpose, suppliers will need to be able to distinguish between

⁵⁰³ Commissions Working Paper on Indirect Taxation and Electronic Commerce, p.13

business customers (taxable persons) and final consumers (non-taxable persons)— in effect to make a taxing decision they need to know if their customer is registered for VAT.

For supplies to non-taxable persons in the Community, no change is proposed and therefore businesses will continue to charge VAT, in the Member State where the supplier is established, as provided for in Article 9(1) of the 6th Directive. For supplies to non-EU customers however, the proposal contains a clear legal base for making such electronic supplies exempt from VAT.

Non-EU suppliers selling to customers in the Community will now be required to apply taxes on the same basis as an EU operator when transacting business in the Community. This means that they must charge and account for VAT on sales to final consumers in the EU. The administrative obligations will however be as light and straightforward as possible for such suppliers. A single registration is envisaged and provision is made for a registration threshold to exclude very small non-Community operators or those making occasional supplies into the Community.

Similarly, this proposal addresses the tax treatment of radio and television broadcasting services supplied on subscription or pay-per-view basis. The convergence of technologies would in any event demand that broadcasting services be included in any proposal on taxation of electronic deliveries. This is an increasingly significant commercial activity, largely directed at consumers, where the existing tax provisions discriminate against European business and give a significant tax-induced price advantage to the non-EU operator.

4.c..Content of the Directive and Evaluation

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The European Council approved the Council Directive amending Directive 77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic means. It includes some arrangements about VAT application to products those delivered electronically.

Directive 77/388/EEC is amended as follows:

(1) In Article 9 (2), the following point (f) is added:

"(f) the *place of supply* by electronic means of services mentioned in point (c) first indent as well as of software, of data processing, of computer services including web-hosting, web-design or similar services and of information, *shall be the place where the customer has established his business or has a fixed establishment to which the service*

is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides, when these services are supplied by a taxable person

- established in the Community to customers established outside the Community; or

- established in the Community to taxable persons established in the Community but not in the same country as the supplier; or

- established outside the Community to persons established in the Community.

For such services however, when they are supplied by a taxable person identified in accordance with the provisions in force to non-taxable persons established in the Community, the place of supply shall be the place where the supplier has established his business or has a fixed establishment from which the service is supplied. For the purposes of point f, *a taxable person established outside the Community shall be deemed to have a fixed establishment in the Member State of identification for services covered by this provision and supplied under that identification.*

For the purpose of this Article the term *"supply by electronic means"* shall mean *a transmission sent initially and received at its destination by means of equipment for the processing (including digital compression) and storage of data, and entirely transmitted, conveyed and received by wire, by radio, by optical means or by other electronic means, including television broadcasting within the meaning of Directive EEC/89/552 and radio broadcasting."*

The above proposal can be summarised as follows:

- for services supplied by a non-EU operator to an EU customer the place of taxation will be within the EU and accordingly they will be subject to VAT.
- when these services are provided by an EU operator to a non-EU customer, the place of taxation will be where the customer is located and they will not be subject to EU VAT.
- when an EU operator provides these services to a taxable person (i.e., to another business) in another Member State, the place of supply will be the place where the customer is established.
- where the same operator provides these services to a private individual in the EU, or to a taxable person in the same Member State, the place of supply will be where the supplier is located.

(2) In Article 12 (3) (a), the following fourth sub-paragraph is added:

With the exception of the reception of broadcasting services mentioned in Category 7 of Annex H, the third sub-paragraph shall not apply to the services referred to in Article 9 (2) (f).

(3) In Article 24 the following point (2a) is added:

"2a Member States shall exempt from tax persons supplying services under Article 9(2) (f) third indent where these are their only supplies made in the Community and their annual turnover does not exceed EUR100,000. This threshold shall be calculated in accordance with paragraph 4."

(4) In Article 28g, Article 21(1) is amended as follows:

(a) in point (a) the following sub-paragraph is added :

"Where a supplier of services under Article 9 (2) (f) has acted with all possible diligence normally used in commercial practice of a given sector and has verified by a consistent set of data from an independent source, notably by means of the individual number referred to in Article 22 paragraph (1) point (c), that his customer is a taxable person established in the Community, Member States shall provide that the supplier be discharged from being liable for tax and that the tax is payable by the person to whom the service is supplied."

(b) Point (b) is replaced by the following:

"(b) *taxable persons* to whom services covered by Article 9(2)(e) and (f) first sub-paragraph second and third indent are supplied or persons who are identified for value added tax purposes within the territory of the country to whom services covered by Article 28b(C), (D), (E) and (F) are supplied, if the services are carried out by a taxable person established abroad; however, without prejudice to the third sub-paragraph of point (a) Member States may require that the supplier of services shall be held jointly and severally liable for payment of the tax;

(5) In Article 28h, Article 22(1) is amended as follows:

(a) Point (a) is replaced by the following:

"(a) *Every taxable person shall state when his activity as a taxable person commences, changes or ceases.* Subject to conditions which they lay down, Member States shall allow such statements to be made by electronic means."

(b) In paragraph 1, the following is added:

"(f) A taxable person established outside the Community supplying services by electronic means as defined in Article 9 (2) (f) third indent to non-taxable persons established in the Community in excess of the threshold provided for in Article 24 (2a)

shall be required to identify for VAT purposes in a Member State into which he supplies services.

(c) In paragraph 4, point (a) is replaced by the following:

“(a) Every taxable person shall submit a return by a deadline to be determined by Member States. That deadline may not be more than two months later than the end of each tax period. The tax period shall be fixed by each Member State at one month, two months or a quarter. Member States may, however set different periods provided they do not exceed one year. Subject to conditions which they lay down, Member States shall allow such returns to be submitted by electronic means.”

(d) In paragraph 6, point (a) is replaced by the following:

“(a) Member States may require a taxable person to submit a statement, including all the particulars specified in paragraph 4, concerning all transactions carried out in the preceding year. That statement shall provide all the information necessary for any adjustments. Subject to conditions which they lay down, Member States shall allow such statements to be made by electronic means.”

(6) In Annex H, Category 7, the words “Reception of broadcasting services.” are replaced by the following: “Reception of broadcasting services, including television broadcasting within the meaning of Directive 89/552/EEC and radio broadcasting.”

The above additional measures can be summarised as follows:

- tax on supplies to business customers will be accounted for by the customer. Registration for tax purposes will only therefore be necessary if supplies are made to private customers.
- registration will not be necessary for non-EU established traders whose annual level of sales within the EU is below €100,000.
- a single place of registration (which will in practice normally be the Member State to where a first taxable supply is made) will be possible. This will enable the operator to discharge all obligations for EU VAT with a single administration. This latter measure effectively puts EU and non-EU operators on an equal basis when supplying to EU consumers.
- it will also be possible to complete electronically all procedures in relation to registration and the making of tax returns.
- tax administrations will provide operators with the means to distinguish easily the status of their customers (i.e., whether the customer is a VAT registered business or

not) and this will normally provide the means whereby a supplier, acting with all possible diligence, can determine whether or not a transaction should be charged with tax.

The European Union approved the Proposal of the Council Directive amending Directive 77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic mean. The new rules, will come into force in July 1, 2003, According to the EU, the new rules will "create a level playing field for the taxation of digital e-commerce." For non-EU sellers, however, the new rules are going to cause new tax compliance headaches. And, EU tax authorities must now figure out how to enforce the rules.

Ch.5A..Conclusion

There should be no fundamental incompatibility between taxation and the new information society but it does raise certain issues. *The electronic marketplace will continue to evolve and tax administrations, like other interested parties, need to plan and react accordingly.* In the light of the current state of development of the Internet, and more particularly the emergence of new business models and new ways of transacting existing business, a full scale review of the existing VAT system would be premature but this cannot be deferred indefinitely. The general provisions dealing with the taxation of services do not reflect the changes that have occurred in international trade since they were first drawn up.

The amendments now being proposed to the 6 th VAT Directive *only serve to highlight the eventual need for such a revision.* In particular, *the current proposal only deals with the narrow area of taxation of on-line electronic services.* The phenomenal increase in trade in services and intangibles cannot be ignored indefinitely. The virtual disappearance of geographical considerations as a limitation on their delivery as well as the development of innovative products highlight the shortcomings in the existing provisions.

Tax administration cannot however limit themselves to simply ensuring that legislation is updated in response to evolving changes in the manner in which taxable economic activity advances. *For e-commerce, the systems, protocols and regulatory environment are still in a process of development. The manner in which they evolve will effect the extent and the manner to which all stakeholders achieve their objectives.* For their part, tax administrations must exercise vigilance to ensure that public interests are

protected. This involves ensuring that e-commerce does not develop in a manner which is not compatible with such interests.

Key objectives must be to ensure that taxes can continue to be fairly administered and that taxable activities cannot be concealed.

The objectives of national governments should not be seen as inimical to the interests of other stakeholders or as hindering the growth of e-commerce. Indeed in the vast majority, if not all cases, they coincide with the general objectives of transparency and the creation of confidence and trust which are essential for such growth. A good example is seen in the recent Communication from the Commission on the organisation and management of the Internet where the need for identification and location of commercial operations was addressed. This is clearly the only way to secure the accuracy of such information and is therefore also a significant interest for tax administrations.

For its part, the Commission has to continue to work to ensure that any aspects of the EU tax system which can be construed as obstacles to the growth of e-commerce are removed. In this respect, the Commission will shortly propose the measures need to remove restrictions on the use of paperless electronic and transaction recording in intra-Community transactions.

The technological changes associated with the Internet and e-commerce provide both an opportunity and a powerful impetus for modernizing tax systems. The Commission has to continue to work to ensure that these benefits are realised.

E-commerce is growing by leaps and bounds. By 2003, the number of people buying on-line will have trebled and transactions will have increased in value twenty-fold. By this time, it is expected that Europe's on-line population will have exceeded America's and companies connected to the web will account for some 80% of the European GDP. So, there can be little doubt that in five years time, a European browsing the net is more likely to be doing so via a mobile device than a computer. Indeed, this is already the case in Japan. Clearly, when the consumer is mobile in a Europe without frontiers, there will be some complex regulatory issues in the areas of applicable law, jurisdiction and VAT that will need resolving.⁵⁰⁴

⁵⁰⁴ SCHULZE Corinna, Don't Panic Do E-Commerce, p.70

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T.C. YÜKSEKÖRETİM KURULU
BEKÜMANTASYON MERKEZİ