

# *Taxation of e-commerce*

*2004*

**Introduction**

Electronic commerce (e-commerce) has the latent to be one of the most eminent economic developments of the 21st century. It offers a fundamentally novel mode of dealing in commercial transactions. It has potentially far-reaching economic and social entailments on many facets of life including the environment, the nature of work, and the function of governments. The economic distance between producers and consumers contracts, new products and markets will be produced, traditional intermediaries are being supplanted and new and far closer relationships will be forged between businesses and consumers and across different segments of global enterprises. Revenue authorities have a role to play in actualizing this potential. There is, at least on the general conceptual level, a wide consensus about the demand for such a set of higher tax principles and even about their universal identification. While much of the attention on e-commerce taxation is concentrated on state sales and use tax quite some amount of work is being executed on the international income taxation also.

E-commerce pioneers would like it otherwise, but the question of whether and how to impose taxes on online sales are not fading away. State and local politicians have made it crystal-clear that exempting online transactions from sales taxes keeps needed funds from flowing into state and local government coffers and harms brick-and-mortar businesses by compelling their customers to pay sales-tax-inflated prices.

**Foreword**

Taxing e-commerce is a global challenge for governments and business alike. It is also not without its controversies.

**Thesis Statement:**

This research paper will explain on the issues related to taxation on e-commerce.

The discussions and recordings of this paper will be limited to the scope of the literature surveyed.

## Issues in Taxation of e-commerce

It is now becoming apparent that e-commerce eases mobile, long-distance, or anonymous transactions when the seller may be external to the territorial power of the taxing government or when the destination of goods and services can be masked (Craig, 2000). Thus, buyers may not have to compensate for sales tax on goods purchased from a seller in a different tax jurisdiction, putting on-e-commerce merchants at a disadvantage and contracting overall tax revenues (Craig, 2000). Income generated by such activity may also be hard to tax fairly. Governments depend on reporting and collection by sellers for the administration of sales taxes, including the European Value-Added Tax (VAT). For income taxes, most international tax mechanisms give priority to the source state. In e-commerce, technology can make it difficult or disconcerting to identify sources (Craig, 2000). Despite the fact that when sellers and the source of e-commerce income can be ascertained, states are by and large unable to enforce tax burdens extraterritorially. Special e-commerce issues arise with electronically conveyed services and digitized products. These include whether a particular transaction involving an intangible should be relegated as a service, as a "license" of rights, or as a "sale" of goods (Craig, 2000). Such transactions range from the provision of customized software to access to data, programs or games held in a server but exhibited on the screen of the user in a different jurisdiction. These issues not only raise sales tax problems but also create uncertainty when income yielded in those transactions could be classified as "business profits" or possibly as "royalties" paid for rights in intangible property (Craig, 2000). Domestic statutes taxing international income and bilateral tax treaty provisions usually dictate separate tax rates and other treatment for "business profits" as compared to "royalties" (Craig, 2000). Taxes levied at international borders on tangible goods are progressively employed to equalize sales or consumption taxation between imported goods and domestically produced competitive products. However, these taxes are not enforced to electronically - conveyed services and products. Threshold issues including the pinpointing of a nexus supporting tax jurisdiction are advanced when electronic messages or devices may conceptually touch the territory of

a state, such as the mere location of a Web server, or the transmission by physical wires or by wireless waves over a state. There is also concern about locating the "place of effective management" to demonstrate the resident state of a corporation (Craig, 2000). Destination becomes a hard concept when the particular product or service being sold or licensed will be "used" in multiple jurisdictions by the buyer (Craig, 2000).

Even when conceptual issues are clarified, by agreement or statute, problems of practical administration exist in the complexity of reporting, registry, and record keeping that must be retained. They also attract attention to privacy issues involved, and the compliance burden placed on taxpayers and businesses charged not only with collection and payment of the taxes, but also with ascertaining the appropriate tax rates to be applied when those rates vary depending on the location of the user.

### **Fundamentals on Taxation of e-Commerce**

Apparently a number of taxation issues are not fresh or unique to electronic commerce but have already evolved in conventional commerce, which increasingly banks on new modes of communications and progressively crosses national borders. According to the Taxation Framework Conditions which were delivered at the October 1998 OECD Ministerial Conference "A Borderless World – Realizing the potential of Electronic Commerce" the principles which should apply to e-commerce are:

#### *Neutrality*

Taxation should seek to be neutral and equitable between forms of e-commerce and between conventional and e-commerce, so as to avert double taxation or unintentional non-taxation.

#### *Efficiency*

Compliance costs to business and administration costs for governments should be derogated as far as possible.

#### *Certainty and Simplicity*

Tax rules should be clear and simple to interpret, so that taxpayers know where they stand.

### *Effectiveness and Fairness*

Taxation should produce the right amount of tax at the right time and the potential of evasion and avoidance should be belittled.

### *Flexibility*

Taxation systems should be flexible and dynamic to ascertain they keep pace with technological and commercial developments.

### **Nexus- what does it connote?**

The ability of a state to impose income taxes or sales or use taxes, or an obligation to collect taxes, depends on whether a "nexus" exists which would abide a state's taxing jurisdiction. "Nexus" essentially means a "contact or link" – a contact or link, which forms the legal basis for the imposition of taxes (Craig, 2000). Only those parties having adequate contacts or links with a state are subject to taxes by that state - some minimum connection or link between the taxing state and the person, property, or transaction it seeks to tax.

Where is the "nexus" in electronic commerce: is it between the seller and his home state, the seller and the state of the customer, the customer and the state of the seller, the customer and his/her state of residence, the internet service provider and their resident state, the internet service provider and the home state of the customer, or the internet service provider and the state of the seller? These doubts still have to be answered. In addition, if nexus subsists for online transactions, the question of what, actually, is subject to sales and/or use tax remains. In general, this counts on how the transaction in question is classified under sales and use tax laws. Normally, governments distinguish between transactions in tangible personal property, services and intangibles and take a variety of approaches to classifying electronic activities under sales and use tax statutes, with little uniformity or guidance in their application. Sales and use taxes are normally levied on retail sales of tangible personal property unless the law provides for a specific exemption or exclusion. "Tangible personal property" typically

includes material goods that may be comprehended by the senses. Services are not generally addressed by sales and use tax unless the law specifically enumerates the services as taxed. Although services are less extensively taxed than tangible goods, over the years there has been a gradual broadening of the tax base for services. Intangibles, such as transfers of stocks and bonds or intellectual property rights, generally are not subject to sales tax. Sales and use taxation of intangible intellectual property rights has been an crucial issue in taxation and, given the important role that licensing plays in electronic commerce, promises to continue to be crucial in the future. Taxation in connection with electronic commerce must also take into account the unique features of the Internet and other electronic networks. Most tax laws and regulations were established before the rise of electronic commerce, and are rooted in concepts of physical location or presence. Determining the identities of the parties who participate in a transaction, where a transaction is "sited," and identifying key "taxing points," for instance, are often important to the administration of taxes (Craig, 2000). These concepts, however, may be difficult to analogize to transactions happening in cyberspace.

### **Industry Reaction**

While governments strive to evolve appropriate methods for taxing e-commerce (likely based on the residence of the consumer), consumers and technology vendors largely take an opposite view – no new Internet taxes.

The Internet Tax Fairness Coalition (a U.S. organization whose members include; AeA (formerly the American Electronics Association, America Online, Inc., Apple Computer, Inc., Cisco Systems, Inc., Direct Marketing Association, First Data Corporation, Information Technology Industry Council, Information Technology Association of America, Microsoft Corporation, Novell, Inc., Oracle Corporation, Software Finance and Tax Executives Council, Software & Information Industry Association, Sun Microsystems) argues that imposing additional taxes on Internet sales could severely hamper existing small and midsize resellers and retailers, and could forestall others from entering the market. They feel that interstate commerce and the economy are burdened by multiple, confusing and

discrepant state tax rules. Therefore, development of a simple and consistent system is critical. They support the following objectives for abbreviating the tax burdens imposed on interstate commerce that thwart the development of a borderless marketplace:

- Establish simple and uniform sales and use tax rules that abridge compliance burdens for all taxpayers.
- Enact nexus standards for business activity taxes that do away with uncertainty and the potential for double taxation.
- Advance availability of the Internet to all by prohibiting taxes on access fees.
- Preclude multiple and discriminatory taxation by extending the application of traditional tax rules to electronic commerce.

### **Managerial significance**

The Internet is a disruptive technology that has caused major alterations in industry structure, marketplace structure and business models. The impact on an organization will depend upon the nature of the industry within which it operates and the homogeneity of its competitors (Craig, 2000). During the next ten years the role of accountants will continue to change dramatically and those who continue to play by the old rules may not be able to survive in the customer-driven new economy. Therefore new forms of accounting such as strategic accounting would appear to have merit. Notwithstanding the importance of strategic accounting and its increasing acceptance by academics and practitioners, strategic accounting research has not yet developed into a widely accepted theory. In fact, failure to create a cross-functional perspective that is congenial during organizational alteration will also contribute to a lack of strategic accounting diffusion.

### **Future Scenario**

It is transparent that if electronic commerce continues to mature (especially if the growth is at the expense of conventional commerce) the question of e-commerce taxation will have to be answered

both at the domestic and international levels. The current dearth of neutrality and basic fairness in e-commerce taxation legislation will become more painfully perceptible (at the heart of the debate is the principle that states and other local governments have the right to tax goods sold within their jurisdiction).

Consequently any future discussion on ecommerce taxation must include the following critical issues (Craig, 2000):

- The proper relationship between federal and the local governments on issues of taxation, and which levels of government ought to bear the responsibility for determining and financing the demands of their citizens and businesses
- The necessity of continuing tax policy neutral so that neither traditional retailers nor remote sellers (catalog, Internet, or similar enterprises) are given an advantage based on tax policy
- The need to cease erosion of essential revenue streams that support education and other key public services at the local level

Again the key technical issues on the table continue to be (Craig, 2000):

- What comprises taxable presence from the use of the Internet?
- What is the tax classification of income from electronic activities (the main consequences being the application of withholding tax and indirect taxes)?
- How are taxpayers identified and their transactions audited?
- What are the implications for transfer pricing and the use of tax havens?

The U.S. is establishing an effort with its Streamlined Sales Tax System for the 21st Century Project. In the meantime, the United States Congress passed the Internet Tax Freedom Act (ITFA) in 1998, temporarily freezing some taxation of ecommerce under state sales tax regimes. Supporters of the moratorium emphasize the potential of e-commerce for productivity growth and are concerned about

the burdens that might be imposed in complying with a multiplicity of varying rules and rates.<sup>16</sup> In 1998, the WTO agreed on a temporary moratorium barring customs duties on electronic transactions, and the World Customs Organization began working on improved transparency. With such efforts in place uniformity may be achieved eventually limiting such burdens.

The European Union, growing more and more occupied about the potential loss of revenue adopted new rules with regards to VAT on electronic commerce, which has come into effect in July 2003. But the new directive has drawn international criticism – the OECD, Japan and the U.S. have all voiced concerns. The Commission justified making its proposals without waiting for the outcome of the OECD negotiations, saying that under the Ottawa Framework, consumption taxes such as VAT should be levied in the jurisdiction where consumption takes place, and that for those purposes, a supply of digital products should not be treated as a supply of goods. It said the new proposals would ensure that the EU VAT system conformed to the framework's principles. Commissioners also guaranteed the U.S. and Japan that they recognized the need for international collaboration on the taxation of e-commerce, but suggested that they were particularly concerned with simplifying European VAT rules to ensure that non-EU operations were brought within their scope as soon as possible. There is growing concern however that this unilateral move by the EU could open the floodgates for other nations to impose e-commerce taxes in an uncoordinated, cost-inflicting patchwork.

The OECD continues its work and is supported by the US in their efforts to create consensus around baseline taxation rules that could under gird the international expansion of e-commerce. While the debate is far from with international “saber-rattling” continuing; the EU has definitely moved the discussion up a notch with its new electronic commerce directive. Only time will tell if their new “consumption-based” directive, and its inherent administrative cost burden, is taking the e-commerce taxation issue in the right direction.

A general increase in reliance on sales taxation, coupled with cuts in income taxation of individuals and corporations, has been a conservative objective for some time, and the revenue needs for war, homeland security, economic stimulus, and maintaining Social Security would supply powerful forces behind expanding sales taxation in the United States. Other forces in the same direction include convergence with the patterns of most of our trading partners, who rely more heavily on sales taxes than on income taxes, as well as recent decisions of the WTO that favor rebates of sales and VAT taxes on exports, while banning income-tax reductions on export sales profits as an illegal subsidy to exports. Therefore, the rhetoric of necessity for reliance on sales taxes under more uniform tax rules is likely to become intense, with the SST dominating in the United States, and both the WTO and the EU continuing to take significant steps as well. E-commerce taxation supplies some genuine policy concerns that would be addressed by uniform tax rules, but may be used as a popular vehicle to promote rules with far wider implications.

## **Conclusion**

As long as traditional forms of commerce face sales taxes, e-commerce should be subject to some form of taxation. It's critical, therefore, that the e-commerce community and federal government leaders begin now to hammer out a taxation policy that will satisfy state and local governments without threatening the growth and vitality of e-commerce.

Unfortunately, e-commerce leaders and federal government officials have, to date, shown a disturbing tendency to bury their heads in the sand. After passing last year's Internet Tax Freedom Act granting the then-nascent industry a three-year tax moratorium, the reds have provided virtually no leadership. Congress' Advisory Commission on Electronic Commerce, formed to decide what should happen after 2001, didn't even meet for the first six months.

Many in the e-commerce community have tried to stonewall the taxation issue. Taxes of any kind, they say, would cripple e-commerce just as it is getting off the ground. But as e-commerce

continues to soar, dramatically altering the competitive landscape in many industries, this position is increasingly difficult to defend.

Unless both the federal government and the e-commerce community begin to deal seriously and creatively with the taxation issue, there's a very real danger that the first stab at an e-commerce taxation scheme will be fatally flawed.

E-commerce leaders should do all they can to ensure that at least part of the proceeds collected from taxes on online transactions goes to supporting the new digital economy, including underwriting more bandwidth and universal Internet access. If e-commerce is expected to carry its share of the tax burden, it's only fair that e-commerce receive its share of the benefits.

## *Bibliography*

Assimakopoulos, N. Systemic Analysis. University of Piraeus, 2001.

Craig, William. Taxation of E-Commerce. Tolley Publishing, 2000.

Kotsimpos, G “Systemic Approach in Electronic Commerce for Electronic Taxation and payment in the internet”, B.Sc.Thesis, Department of Informatics, University of Piraeus.2000.

OECD Committee on Fiscal Affairs “Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions”. June 2000.

OECD Committee on Fiscal Affairs Clarification on the Application of the Permanent Establishment Definition in E-Commerce: Changes to the Commentary on the Model Tax Convention on Article 5.2000.