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Taxation of Electronic Commerce: A Developing Problem.

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Abstract:

The rapid growth of e-commerce, especially the sale of goods and services over the Internet, has fueled a debate about the taxation regimes to be used. The shift from a physically-oriented commercial environment to a knowledge- based electronic environment poses serious and substantial issues in relation to taxation and taxation regimes. Tax administrations throughout the world face the formidable task of protecting their revenue base without hindering either the development of new technologies or the involvement of the business community in the evolving and growing e-market place. Concerns, for governments, centre on the impact of e-commerce on the state and local revenue. Whereas states can impose a tax on residents' purchases from out-of-state vendors, they cannot impose an obligation on those vendors to collect the tax unless the vendor has a substantial presence, or nexus, in the state. The problems for developing countries we believe are greater. The shrinking of the tax base will have a disproportionate effect and further jeopardise the already fragile economy of the developing world.

Introduction:

Taxation acts as a tool of good governance, allowing economies to grow while helping to improve society as a whole (Johnston, 1999). Electronic commerce and globalisation are challenges to traditional tax regimes. Historically goods were physical, the production, distribution and consumption of these goods was easily taxable. Physical goods were produced at a manufacturing plant, shipped off to wholesalers and boxed on retailers shelves, with the final consumer walking away with a paid for (and taxed) product. Tax collection was in the hands of the retailers. The retailer charges the consumer VAT or sales tax and then remits this to the government.

Globalisation makes the cross-border movements in goods, capital and labour less transparent allowing companies and individuals to exploit tax differences between countries. The Internet eliminates borders between countries making businesses virtually invisible. Any taxation solutions adopted should be efficient, simple, flexible and have neutral effect.

Consumption Taxes and Intangible Goods

The challenges posed by electronic commerce for taxation have been well documented by the OECD. They include (OECD, 1998); how to identify taxpayers engaged in electronic commerce and determine their taxing jurisdiction; how to ensure that appropriate records are created of business conducted by electronic commerce; how to collect taxes in the electronic commerce environment. In this paper we concentrate particularly on the possible decline in the overall tax base which in our view will have a disproportionate effect on the economies of the developing countries. This decline is even more pronounced where reliance is placed on consumption taxes,

Consumption taxes, or sales taxes, are intended to be borne by consumers, and are dependant upon retailers acting as tax collectors. If not properly designed, however, sales taxes may impose an economic burden on business. Sellers bear the cost of determining the applicable tax rate, which may depend on the type of product and the location and type of customer; preparing invoices according to tax rules; collecting tax; filing and remitting tax; and maintaining tax records. If the tax is assessed incorrectly, the seller (or its third- party agent) typically will be held responsible for any shortfall and will not be able to reclaim it from the customer.

Intangible products include products such as music, software and services such as medical or legal consultations (Lukas, 1999), that are " produced" at one location and "consumed" somewhere else. It is generally accepted that tax rules for sale of intangible products and services should be same, as those of other goods, that the means of delivery should not govern tax treatment. Such "technologically neutral" taxation would not treat the sale of a paperback book any differently than the sale of a digitised book. On the other hand, determining which products are functionally equivalent is a tricky proposition. Is the text displayed on computer screen really the same thing as a printed book? Is a movie downloaded to computer hard drive really the same thing as a video rental? The answer is not obvious. 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. Moreover most of the countries do not have comprehensive taxation to services and few intangible products aside from basic utilities, which are subject to special taxes.

At present, countries have different and inconsistent rules for different types of services and intangible property, such as telecommunications, broadcast, consulting, engineering, training and education, data processing, supply of information, access to databases, entertainment, and content of various types. Attention should be given to developing consistent definitions, classifications, and tax rates for the many types of services that might be considered to be a part of electronic commerce.

This effort not only would provide clarity and certainty, but also should reduce double taxation and attempts to manipulate classifications to avoid taxation. Consistent guidelines also are needed for combined or bundled services, e.g., telecommunications and internet access, which combinations may be difficult to separate out, especially if they are subject to different rules or tax rates. It is also increasingly common to bundle free services with purchased services.

Another issue to be addressed is apportionment of use of services within and without a country, e.g., telecommunications services or use of an Intranet network. Cooperation on compliance issues could be handled under possible bilateral or multilateral agreements.

E-Commerce:The Challenge

E-commerce provides a qualitively different challenge to tax regimes than has appeared before. The 1980's saw the rise of the "big box" stores, whose goal was not so much to feed off and feed into indigenous community-based businesses but rather to crush them, to be the only retail destination in town. Big box stores frequently demanded tax abatements from communities in exchange for the promise of big sales tax windfalls and increased local employment. Independent merchants, who have always thrived in main street districts, have traditionally done more than sell goods to local shoppers. They support the local economies in a myriad of ways: by buying supplies from other local stores; employing the services of local lawyers, architects, accountants, and plumbers; banking at local banks and employing local builders and craftsmen. They contribute non-economic assets to communities as well.

The proper metaphor for e-commerce activities of Internet-only merchants is that of colonialism exploiting local markets by taking resources out of the community without returning anything in kind. Local officials ought to be concerned about this because local businesses are the ones who are working to bring economic and cultural enrichment to their communities and who are bearing the burdens of sales tax and property tax collection (Ross, 1999). Internet businesses take the colonialism economic model of chain stores one-step further. At least chain stores collect sales tax, pay property taxes, and hire local workers. Internet-only businesses evade most of these activities, which are critical to the survival of communities and local economies. Whereas states can impose a tax on residents' purchases from out-of-state vendors, they cannot impose an obligation on those vendors to collect the tax unless the vendor has a substantial presence, or nexus, in the state.

Taxing online sale of intangible is problematic because the location of customers cannot be known with certainty. Many online shoppers do not feel comfortable giving unnecessary personal information to a web site. Consequently, they may refuse to type it in, shop at a site that does not require it or simply lie. This will probably lead to multiple taxation or non-taxation.

Erosion of the Tax Base - Reduction in total tax income

Historically, mail order operations have not been required to collect sales taxes in states where they do not have a physical presence or "nexus." With the rise of e-commerce, however, this issue has become of great concern to states and communities who justifiably fear a huge loss of revenue with the exponential growth of e-commerce, which now evades state and local sales taxes. A moratorium on taxation of Internet sales would benefit affluent consumers at the expense of those with low and moderate incomes (Mazerov, 1998).

E-commerce merchants have a major competitive advantage over community-based businesses; e-tailers can avoid collecting sales tax. Taxes are the principal source of government revenue, accounting on average for about 80 per cent of total revenue (all countries). Domestic taxation of goods and services makes up the largest share in tax revenues (36.5 per cent)[1]. Revenues from import duties account on average for 13.2 per cent of total revenue and 17.5 per cent of tax revenue. Major differences exist between developing and developed countries: for the former, import duties as a share of total government revenue are 15.8 per cent (compared with 2.6 per cent for developed countries) and as a share of tax revenue 21.2 per cent (compared with 3 per cent for developed countries)[2].

The combined tax revenues from goods and services and those from imports account for 54 per cent of tax revenues (all countries), or 58.3 per cent of developing countries' and 37 per cent of developed countries' tax revenue. Hence, they make up a major source of government revenue in most countries [3].

The erosion of the consumption tax base resulting from e-commerce has caused considerable concern among Governments, given the steep growth of e-commerce in the past years and predictions for the next five years. Consumption taxes are borne by the consumer and collected by the seller; different rules apply depending on the product or service sold, the location of consumer and seller, and the type of consumer (business or individual). With e-commerce, the number of foreign on-line suppliers, who are often subject to different taxation rules, has increased considerably. Research carried out in the United States on the impact of taxation on Internet commerce and consumer on-line purchasing patterns found that consumers living in high sales tax areas are significantly more likely to buy on-line than those living in low sales tax areas (Goolsbee, 1999). Hence, differentiated Internet taxation rules among countries could have a significant impact on consumers' purchasing behavior, shifting from domestic to foreign suppliers[4].

This raises several problems for tax authorities. First, it leads to the gradual elimination of intermediaries, such as wholesalers or local retailers, who in the past have been critical for identifying taxpayers, especially private consumers. Second, foreign suppliers may be tax-exempted, whereas local suppliers are normally required to charge value added tax (VAT) or sales taxes. Third, direct orders from foreign suppliers could substantially increase the number of low-value shipments of physical goods to individual customers. These low-value packages now fall under so-called *de minimis* relief from customs duties and taxes in many countries, basically to balance the cost of collection and the amount of tax due. A substantial increase in these shipments as a result of e-commerce (where foreign suppliers replace domestic ones) could pose an additional challenge to tax as well as customs authorities.

Major differences exist between the EU and the United States in the way taxes are redeemed and hence in their approaches to international taxation rules on e-commerce. The EU countries derive a large proportion of government tax revenue from consumption taxes on domestic goods and services (mainly VAT) (29 per cent). In addition, VAT extra charges contribute 45 per cent to the EU Community budget (in addition to customs duties and GNP contributions)[5].

Their main concern is the increasing import of digital content and services from outside the EU, which would be exempted from VAT payments in the EU. The United States government, on the other hand, derives most of its tax revenues from personal and corporate income tax and social security contributions.[6] The United States is currently both a net exporter and the main exporter of e-commerce worldwide. Hence, it has a great interest in encouraging business (including e-commerce business) to locate in the United States and pay direct taxes to United States tax authorities.

It is not surprising, therefore, that the issue of consumption taxes has received most attention in the OECD and the EU. In particular, the EU feels very strongly about maintaining VAT duties and is likely to modify tax rules in a way that will ensure a continuation of VAT contributions, rather than lowering or eliminating them. A closer look at current VAT regulations in the EU will explain the growing concern among EU tax authorities and Governments[7].

Imported goods from non-EU members are subject to (import duties and) VAT of the importing country. Sales within the EU are subject to the VAT of the receiving country in the case of business-to-consumer trade. Businesses selling to businesses in another member State are tax-exempted; the receiving or importing business is required to pay VAT locally (i.e. in the country of final consumption).[8] Exports to non-EU countries are zero-rated.

Services differ according to the type of services traded. In the case of information (currently the majority of e-services), imports from non-EU businesses to EU consumers are not subject to customs duties and are VAT-exempted (except for Denmark, France and Italy). Sales from non-EU businesses to EU businesses are subject to self-accounted VAT at the local rate (a so-called reverse charge). Intra-EU service suppliers are required to charge VAT in the country in which they are established (location of the seller), if selling to private consumers. EU-business-to-business services trade is subject to VAT in the country of the final consumer. Sales to customers outside the EU are subject to VAT in the location of the seller (Kerrigan, 1999).

The challenges to EU tax authorities that arise from e-commerce therefore lie in non-EU supplies of e-services to EU customers (and in an increase in non-EU customers not subject to EU VAT). Under current tax law, these are exempted from VAT, while at the same time their share is increasing, in direct competition with EU suppliers who are subject to VAT payments. Furthermore, the VAT exemption provides incentives for suppliers to locate outside the EU, a fairly easy undertaking in e-commerce, which no longer requires the presence of human and technical resources.

How will these revenues be affected by e-commerce? Will the increase in digital trade substantially reduce revenues from import duties and taxation of domestic goods and services? The decline in the tax base in e-commerce will be caused by the loss of consumption-based taxes resulting from the difficulty in taxing purchases from outside the jurisdiction. This will be aggravated by the loss of tax revenue from workers displace by new information technologies. To this "double whammy" will be added the increase in tax avoidance made easier by the lack of paper trails on the Internet.

Countries will be encouraged to move to more direct taxation systems, resulting in less fairness in the tax system, direct taxation systems impacting more on poorer families. It is our contention that these consequences will impact disproportionately on developing countries.

Erosion of the tax base, the move from fair taxation.

As Internet sales become a more significant share of consumption, states and localities will likely see taxable sales -- and sales tax revenues -- diminish. States and local governments could raise their sales tax rates to maintain revenues if they were unable to tax Internet sales. But sales taxes are regressive; they absorb a larger share of the incomes of lower-income households than of wealthier households. Sales tax rate increases could set off a vicious cycle leading to ever more regressive sales taxes. As tax rates rose, higher-income households and businesses with Internet access would have ever greater incentives to make their purchases on-line to avoid taxes, while lower-income households without sufficient resources to get on-line would remain liable for the taxes. Sales tax liability would be more and more concentrated among the lowest-income segments of the population.

Similar inequities for low-income households would be created if, instead of raising taxes, state and local government programs were reduced to compensate for diminished revenues. History suggests that in time of fiscal shortages, services for lower-income families and individuals tend to be cut disproportionately.

In fact, the mail-order loophole is already shifting the overall sales tax burden toward low and moderate-income households, because upper-income households also disproportionately make mail order and telephone purchases.[9] The inequitable impact of the mail-order loophole on the distribution of the sales tax burden is one major reason why a new federal law is needed to permit states to require most large interstate businesses -- including large Internet merchants -- to collect sales taxes.

People who make purchases through the Internet are, on average, more affluent than those who do not are. This stands to reason, since a person making an Internet purchase generally must have a personal computer with a modem, a connection to the Internet through a service provider, and a credit card with which to pay for the purchase. Lower-income households would lack the equipment to access the Internet, the training to use the equipment, and/or the financial stability and credit rating required maintaining a credit card.

The *Wall Street Journal* notes that income and education are linked to the ownership of personal computers. Media Metrix reports that Internet users own the most powerful and expensive computers (Metrix, 1998). Moreover, the Internet is increasingly being used to make purchases of luxury items. A recent article describes how the Internet is especially well suited for consumers who want to customise their purchases of golf clubs and bicycles from hundreds of possible specifications.[10]

The relatively more affluent segments of the population who use the Internet would benefit disproportionately from the tax-free e-commerce. A person with sufficient means to have a computer and Internet access could, for example, avoid taxation on the purchase of a good or service that would be taxed if a person without such access purchased the same or similar good or service from a neighbourhood store. But the tax break for the affluent would likely come at the expense of higher taxes or fewer services for state residents of more modest means.

There is no compelling policy reason why the governments should do favour the wealthy and well-financed corporations and their equally wealthy customers at the expense of other businesses and other consumers. Community-based businesses and the cities and towns they serve are now endangered by unfair and ill-conceived economic distortions due to the tax breaks e-commerce companies enjoy. We accept that governments should refrain from doing anything that possibly can cause hindrance to the growth of e-commerce, but one should not forget that for the growth of e-commerce it is essential that there is considerable development in the infrastructure which supports the growth, erosion of tax base will substantially cut the investment in these this area.

Developing Countries

How does consumption tax legislation affect developing countries? Most of them rely heavily on consumption taxes for their government budgets. Given that many developing countries will be net importers of e-commerce in the medium term, they would have a strong interest in not eroding their tax bases by switching to an origin-based tax system. They need to be aware, however, that tax collection on e-commerce activities will require access to the latest technologies by tax authorities. Thus, developing countries need to catch up on modernizing their tax administration systems in order not to lose important tax revenues on the collection of consumption taxes.

Developing countries could be much more affected by fiscal losses resulting from e-commerce in view of their greater dependence on tariffs and taxes as revenue sources for their national budgets. Developing countries by and large are capital-importing countries. For a developing nation, this means its citizens and companies tend to buy from foreign countries more than foreign countries buy from its citizens and companies. In general, developed countries consist of relatively wealthy, capital-exporting nations. On the other hand, developing countries consist generally of relatively poor, capital-importing nations. Whereas the flows of income between developed nations tend to be more or less balanced, the flows of income between developed and developing nations tend to be unbalanced in favour of the developed (capital-exporting) nation. While the size of these export-import trade deficits vary from year to year and from country to country, such deficits nevertheless overwhelmingly exist for developing countries.

The main players in the debate on e-commerce taxation have been the United States, the EU and the OECD[11]. The United States and the EU member States are primarily concerned with how their respective tax systems will be affected by e-commerce.[12] The OECD secretariat, whose Model Tax Convention serves as a basis for most bilateral tax treaties (including between non-OECD member countries), has been asked by its member States to take the international leadership role on e-commerce and taxation, a mandate that was confirmed at the 1998 OECD Ministerial Meeting in Ottawa. It has prepared a number of taxation principles that should govern e-commerce and has worked closely with the EU on consumption tax issues.

While it is true that developing countries' shares in e-commerce are still modest, the international rules and regulations that are adopted now will impact on e-commerce in many countries in the future, including in the developing countries. In addition, the increasing numbers of small and medium-sized enterprises (SMEs) that will be drawn in by e-commerce from the developing countries have little experience in international taxation issues. It is therefore crucial to include their concerns as early as possible.

Any solutions must have the confidence of the developing world.

"Above all, what is needed is a recognition that globalization is not merely a matter of unrestricted market forces. It requires a strengthening of international standards and cooperative arrangements, to provide a basis of mutual confidence." (Picciotto, 2000)

No matter what changes to existing tax legislation are adopted, without a certain degree of international cooperation and harmonization of existing tax rules, the expansion of e-commerce will be hampered. Traditionally, tax collection has been based on the belief that individual countries have the right to set their own tax rules and little international cooperation and few multilateral agreements have been put in place. Unless this approach changes and countries agree to enter into multilateral tax agreements, tax competition will intensify with e-commerce. This is a likely scenario given that, even within the OECD, individual countries implement domestic tax rules that give them a competitive edge[13]. This is also why it is unlikely that countries will collect taxes for other countries, for example in the case of VAT, where it has been suggested that VAT be collected from the country of the supplier[14]. On the other hand, if rules are not harmonized internationally, the risk of double taxation may keep foreign suppliers/competition out; and non-taxation may distort competition against local suppliers.

With a few exceptions, developing countries will not be part of an OECD agreement on Internet taxation. Nevertheless, they can use the principles and rules agreed upon as a basis for adjusting their own legislation. For example, developing countries have used tax legislation in the past to attract private foreign direct investment (FDI). Multinationals increasingly operate in countries that have low taxes or are willing to negotiate favorable tax regimes to attract foreign business[15]. In fact, fiscal incentives are the most widely used type of FDI incentives[16]. Depending on the agreements adopted in the OECD, developing countries could negotiate specific bilateral treaties for e-commerce taxation, which would give them a competitive edge. For example, the transaction costs of setting up or moving a web server are low; hence, e-commerce allows companies to respond quickly to tax incentives by Governments and move their web servers to a developing country.

Any decisions, which developing countries may take on modifying their tax legislation to accommodate e-commerce, however, will have to take into account the significant role of tax and tariff revenues in their national budgets. Until new international agreements on e-commerce taxation have been defined, an increasing number of goods and services will be traded on-line, largely tax-free. This will have an effect on government revenue, especially if the goods and services have been subject to import duties in the past. In order to capture some of these (potential) revenue losses, the following section will analyse data on trade, tariffs and other import duties for a number of goods that are already supplied on-line or are likely to be so in the near future.

Figures for the United States (to our knowledge no work has been done on this from the perspective of the developing countries) show the scale of the problem. State and local governments, which already may be losing in the order of $5 billion in sales tax revenues annually from their inability to tax most mail-order sales, could be losing an additional $10 billion annually in just a few years if Internet purchases remain effectively tax-exempt[17]. This loss of revenue could significantly impair the ability of some states and localities to meet demands for education funding and other services that enable the disadvantaged to get ahead in an increasingly technology-oriented economy**.** Numerous studies project hundreds of billions of dollars in annual purchases by consumers and businesses over the Internet just three to four years from now. Not all such purchases represent lost sales tax revenues to state and local governments, of course; some will be goods and services that are not taxed, and others represent purchases upon which the tax will be remitted by the seller or the purchaser. Nonetheless, given current growth projections for electronic commerce, state and local governments conservatively could be losing $10 billion in tax revenues annually in just a few years from untaxed Internet sales -- this in addition to losses from traditional mail-order purchases.[18]

Even assuming no growth in traditional direct marketing sales between now and 2003, the combined annual revenue loss from untaxed Internet and mail order sales in 2003 could be $15 billion ($5 billion in lost revenue from untaxed mail-order sales plus $10 billion from Internet sales). That should be regarded as significant by any objective standard; it is, for example, more than two and one-half times what state and local governments currently spend on public libraries.[19]

It is the equivalent of $50,000 salaries for 300,000 teachers. The economic opportunities available to the poor could be reduced if tax base erosion impairs the ability of states and localities to finance public services, such as education, job training, library, childcare, health, and similar services[20].

To avoid double taxation, some multi- or bilateral agreements have to be adopted on where consumption taxes are to be collected: in the country where the supplier is established, the country where the customer is established or the country of consumption. A proposal by the EU to require non-EU suppliers to register for and charge VAT in a EU country would not favor providers from developing countries, thus placing an additional burden on their e-commerce exports.

Global Initiative for Addressing Tax-Related Issues in E-Commerce

A. OECD Response

The OECD has prescribed certain guidelines that they feel governments should adhere to while formulating new provisions regulating taxation of e-commerce transactions. It's helpful to revisit these guidelines, which are summarized as follows, (OECD, 1998):

1. the technologies underlying electronic commerce offer governments significant new opportunities to improve taxpayer service, and that those opportunities should be pursued;

2. the taxation principles that guide governments in relation to conventional commerce should quite properly guide governments in relation to e-commerce: those principles being neutrality; efficiency; certainty and simplicity; effectiveness and fairness; and flexibility;

3. those principles can be implemented for e-commerce through existing tax rules, albeit with some adaptation of the latter;

4. there should be no discriminatory tax treatment of e-commerce;

5. application of these principles should maintain fiscal sovereignty of countries, ensure a fair sharing of the tax base between countries, and avoid double and unintentional non-taxation; and

6. The process of putting flesh on these principles should involve intensified co-operation and consultation with economies outside of the OECD area, with business and with non-business taxpayer groups.

7. When required, government intervention should be proportionate, transparent, consistent, and predictable, as well as technologically neutral.

At the time of the 1998 OECD Ministerial meeting on electronic commerce, it was proposed that the OECD form Technical Advisory Groups (TAGs) to assist in taking forward the work on taxation and electronic commerce. Five TAGs were established in January 1999 for two years to allow them time for a thorough consideration of all the issues. The Consumption Tax TAG is examining consumption taxes and electronic commerce in the following areas:

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 digitized products should not be treated as a supply of goods;

3. Where business and other organizations 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; and countries should ensure that appropriate systems are developed in co-operation with the World Customs Organization 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.

Since it is unlikely that non-EU sellers will collect taxes from their EU customers for EU tax authorities (or any foreign supplier for another country's tax authorities), it seems reasonable to move VAT collection to the place of consumption, away from the location of the seller[21]. Here, a key problem for tax authorities will be to identify the customer and the location of the jurisdiction responsible for collecting the tax. Because of the process of disinter mediation, apart from the seller and the customer there are no other parties involved in the transactions (which could collect the tax). Credit card companies, Internet service providers (ISPs), banking and payment systems providers or telecommunications companies have been mentioned as potential new intermediaries in verifying the location of a customer and the respective tax jurisdiction.

This, of course, raises privacy issues and possible abuses of information. It could also lead to an increasing use of foreign credit cards or digital cash; needless to say, the customer's location may differ from the billing address. In addition, how can an Internet seller determine whether the customer is a business or an individual consumer, each of which is subject to different VAT rules? An increasing number of e-commerce businesses are small entrepreneurs operating from home who may receive services for business or personal purposes.

The OECD proposal to treat digitized products as services corresponds to a EU proposal that for VAT purposes trade in digital goods be treated as a supply of services. The EU also proposes that VAT rates on all e-services be harmonized into a single rate. This could result in tax losses since consumption taxes are lower on services than on goods. It could also lead to losses on tariffs and import duties on digital goods that were shipped physically in the past and which would now be subject to much lower duties. This would impact in particular on the developing countries, whose reliance on import duties as a government revenue source is much higher than in the developed countries.

At the Ottawa Conference, the United States took a different position on this issue: digital products should be characterized on the basis of the "rights transferred" in each particular case. It argued that some goods which are now zero-rated (such as books or newspapers) would be subject to VAT if treated as a service. Customers may therefore prefer to buy local zero-rated books rather than digitally imported (and taxed) services, many of which could be supplied by United States on-line providers.

As an alternative, the United States has proposed an origin-based consumption tax for intangibles (e-services), which would be collected from the supplier and not from the consumer. It argues that it is easier to identify the supplier than the customer on the basis of permanent establishment rule (see below) and since businesses are subject to audit. The United States as a net exporter of e-commerce would benefit from an origin-based tax, while it may further erode the tax base in e-commerce-importing countries. On the other hand, it disadvantages domestic producers in their export sales since they would have to pay the tax on the exports, instead of the final consumer. This may encourage business to set up shop in countries with no origin-based taxation. Finally, one needs to keep in mind that most e-commerce will be business-to-business (currently 80 per cent of e-commerce), which is often tax-exempted or subject to voluntary compliance[22].

There is a growing environment of trust and co-operation between tax authorities and the business community, which will prove useful in the drive to reach satisfactory tax solutions in electronic commerce. Obviously governments around the world, both inside and outside the OECD, will have to co-operate with each other too. Some of that co-operation is already in evidence. Several non-OECD countries were involved in the Turku tax roundtable on electronic commerce in 1997 and participated in the dialogue on tax and electronic commerce in the run-up to the OECD Ministerial conference in Ottawa in October 1998.

B. Development within the EU

In June 1999, The European Commission issued a Working Paper concerning a revision of the current tax rules of the 6th VAT Directive for both goods and services, regardless of the medium through which these items are sold[23]. The paper also recognizes the need to apply existing taxation rules effectively. It acknowledges that VAT procedures tend to be overly complex and the delays in obtaining refunds of VAT paid in other Member States are a major disincentive to cross-border trade. The Commission has already made proposals to simplify these issues in the short term, via abolition of tax representatives and replacement of VAT reimbursement by a right of deduction. Existing VAT rules will also be modernized to take into account the evolution of business, and particularly e-commerce.

On June 7, 2000, the European Commission presented a proposal for a Directive[24] to modify the rules for applying value added tax (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 level playing field for the taxation of digital e-commerce in accordance with the principles agreed to at the 1998 OECD Ministerial Conference and to make compliance as easy and straightforward as possible. The proposal mainly concerns the supply over electronic networks (i.e. digital delivery) of software and computer services generally, plus information and cultural, artistic, sporting, scientific, educational, entertainment or similar services. The proposal would ensure that when these services were supplied for consumption within the European Union, they were subject to EU VAT, and that when these services were supplied for consumption outside the EU, they were exempt from VAT. The changes modernize the existing VAT rules to accommodate the emerging electronic business environment and to provide a clear and certain regulatory environment for all suppliers, located within or outside the EU.

The proposal also contains a number of facilitation and simplification measures aimed at easing the compliance burden of business. According to the EU, the current VAT rules do not, however, adequately address the supply of services delivered online by digital means, notably as regards such services traded between EU and non-EU countries. Such supplies were simply not envisaged at the time the current VAT legislation was established. As a result, application of the current VAT rules to electronically delivered services produces discriminatory results. At the moment, 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. Under the proposal, the application of VAT would depend on the tax status and location of the recipient. Electronic services delivered from one Member State to businesses located in another Member State within the EU would be generally supplied without VAT, with the VAT paid by the business customer on a self-assessment basis with his regular VAT returns (the so-called `reverse charge mechanism'). Where electronic services were delivered from one Member State to consumers in another Member State within the EU, the supplier would continue to charge VAT at the applicable rate in the Member State where the supplier was registered. Under the proposal, non-EU operators would only have to register for VAT purposes where they undertook business to consumer transactions. They would not have to register if they undertook only business-to-business transactions because business customers pay the VAT themselves on a self-assessment basis under the so-called `reverse charge mechanism'. Where their annual sales to consumers in the EU exceeded a minimum turnover threshold of E100, 000, 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.

C. Development within the United States

On April 12, the Advisory Commission on Electronic Commerce presented to Congress the results of its 10-month study of the issues of taxes and the Internet. Although the commission was unable to generate the two-thirds majority vote required by the act to send a "formal" recommendation to Congress on the subject of taxing electronic commerce, a simple majority of its 19 members did agree on a fairly comprehensive plan that addresses many Internet and telecommunications tax policy issues.

The proposal includes:

* Extending the current moratorium on Internet taxes for five years;

* Prohibiting the taxation of digitized goods and products and their non- digitized counterparts;

* Banning all taxes on Internet access;

* Abolishing the federal excise tax of 3 percent on telephone calls;

* Encouraging state and local governments to reform industry-specific telecommunications taxes;

* Establishing firm "nexus" rules for electronic commerce to make it clear when state and local governments could levy taxes on vendors of interstate commerce;

* Encouraging state and local officials to work together to simplify their sales tax collection systems and make them more uniform; and

* Establishing a new Advisory Commission to monitor these ongoing efforts and to determine whether states and localities should be allowed to collect taxes on out-of-state Internet vendors once tax code simplification is complete.

One of the most fundamental issues before the Commission concerned the application of state and local sales and use taxes to Internet and other remote retail sales. Sales taxes are "consumption-type" taxes designed to generate revenue. In general, these taxes are calculated and collected by businesses at the point of sale and remitted to the appropriate taxing authorities. While the exact impact of e-commerce on sales tax revenues may be uncertain, clearly the need for substantial sales tax simplification is necessary in this emerging digital economy. In the course of the Commission's examination of the impact of e-commerce on sales and use tax collections, there was general agreement among the Commissioners that the current sales and use tax system is complex and burdensome. Most, if not all, of the Commissioners expressed the view that fundamental uniformity and simplification of the existing system are essential. The need for nationwide consistency and certainty for sellers as well as the need to alleviate the financial and logistical tax collection burdens and liability of sellers were common themes throughout discussions. Commissioners also identified issues raised by sales of digitized goods over the Internet. They discussed the challenge of determining the identity and location of the consumer of digitized goods and the need to protect consumer privacy rights.

The Commission's proceedings helped widen public awareness of the issue and provided an exceptional framework for debating complex tax issues.

Conclusion.

An increasing amount of e-commerce is done in digital that is in non-physical form where the existence of customers and payments methods are not traceable. E-commerce increase the gap between the technology exporting developed country and technology importing developing countries, and between those countries whose primary tax base is direct taxation and those which raise substantial amounts of revenue by consumption taxes. The threat is of deepening the developing countries disadvantage in competing with developed nations.

The effect is that the opportunities and threats brought by e-commerce are quantatively and qualitatively different as between developing and developed countries. International strategies and methodologies derive from organisations such the OECD, organisations dominated by the US and the developed world. The result is solutions devised for and beneficial to the developed world. Developed countries have the financial strength to withstand the probable revenue loss, most developing countries have huge budgetary deficit and any change in the revenue base will jeopardise the already fragile economy. In addition the growth of e-commerce is directly related to the infrastructure development hence with the revenue loss this development will also be hampered.

The present initiatives appear to ignore or side step this difference. Developing countries have seen the prospective of economic growth due to e-commerce and followed the UNCITRAL Model Law on Electronic Commerce[25], yet so far have ignored the probable revenue loss. Industrialised countries have in turn reviewed options including zero tax options to boost e-commerce ignoring the fact that developing countries are already short of resources and a zero tax on e-commerce will result in a huge potential loss of revenue for them. Practically all the benefits of a zero tax policy will go to industrialised countries. The multination corporations of the developed countries will therefore have a strategic weapon to gain competitive advantage in this digital age over the local companies of the developing world, increasing the gap between the developed and developing world.

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[1] Mainly sales and value added taxes.

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

[3] Other important sources not considered here are income taxes and social security contributions.

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

[5] The 45 per cent contribution in 1997 was reduced to 35 per cent in 1999 (projection) (European Commission, 1998).

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

[7] For details and facts on EU VAT rules, European Commission (1997). The complexity of the existing EU VAT system is considered by business a major barrier to developing e-commerce in Europe.

[8] This regulation was put in place in 1993 under the "transitional VAT arrangements", with the objective of removing border controls for tax purposes inside the European Community.

[9] Statistics form Direct Marketing 1997

[10] 'Build It Yourself - http://www.internetworld.com/print/current/ecomm/19980302-build.html

[11] Business as well as government institutions have participated in these debates and made proposals on how to handle Internet-related tax questions. While business interests are less of a concern in this paper, it should be noted that they mainly relate to avoiding double taxation and to simplifying indirect taxation that arises from inconsistencies among definitions, classification, source of supply rules for services, registration requirements, reverse charges, collection etc. For further discussion, see Global Information Infrastructure Commission (GIIC) website at www.gii.org.

[12] In 1998, the United States Congress created the Advisory Commission on Electronic Commerce under the Internet Tax Freedom Act, to study a variety of issues involving e-commerce taxation, including international issues. The Commission is collecting proposals from the public and private sectors for consideration, which will contribute to the final report and recommendations it will provide to Congress no later than April 2001. At its final meeting in March 2000 (Dallas, Texas), the Commission voted, among others, to extend a three-year moratorium on domestic "new" Internet taxation imposed by the Internet Tax Freedom Act and due to expire at the end of 2000. However, no solutions have yet been provided on the question of state and local tax collection, a major concern to local governments. Within the EU, various bodies have addressed and prepared background documents on Internet taxation (e.g. the EU's Taxation Policy Group, the EC Directorate-General on Taxation and Customs Union).

[13] And even within the EU, VAT differs among member states.

[14] The Economist (2000b), *A Survey of E-commerce*, 26 February 2000.

[15] The Economist (2000b), *A Survey of E-commerce*, 26 February 2000.

[16] UNCTAD (1996). *Incentives and Foreign Direct Investment*, UNCTAD/DTCI/28, CurrentStudies, Series A, No. 30, Geneva.

[17] The U.S. Advisory Commission on Intergovernmental Relations estimated the nationwide state and local government revenue loss from untaxed mail order sales in 1994 at $3.3 billion. (Taxation of Interstate Mail Order Sales, 1994 Revenue Estimates.) According to the Direct Marketing Association, catalog sales grew 8.6 percent annually between 1994 and 1999. If all forms of direct marketing matched the growth in catalog sales during the 1994-9 period and the share of all such sales going untaxed remained constant, a rough estimate of untaxed mail order sales in 1999 would be $5 billion.

[18] Forrester expects business-to-business sales over the Internet to remain many times larger than consumer purchases. Forrester currently projects $1.3 trillion in U.S. business-to-business Internet sales in 2003. (See: "The Online Revolution," *Wall Street Journal*, July 12, 1999, p. R6.) If just one-third of these sales represent items that would be subject to state and local sales taxes, and if it is assumed that just one-third of the taxes due on this one-third of sales would go uncollected, then the 2003 revenue loss from untaxed business-to-business Internet sales (at the average 6.5 percent tax rate used by Duncan) would be $9.6 billion. (Assuming that one-third of the $1.3 trillion would be subject to sales tax seems reasonable. Computers, industrial equipment, office supplies, and shipping supplies alone account for 40 percent of the total; such items generally do not qualify for sales tax exemptions). Combining the $9.6 billion in lost revenues on business-to-business sales with the $4 billion in lost revenues on consumer purchases estimated by Duncan yields $13.6 billion. Thus, an estimated $10 billion total revenue loss from untaxed Internet sales in 2003 appears reasonable, if not conservative.

[19] According to the U.S. Census Bureau, state and local governments combined spent $5.7 billion on libraries in FY95-96, the most current fiscal year for which data are available. See: www.census.gov/ftp/pub/govs/estimate/96stlus.txt

[20] UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT, Policy Issues in International Trade and Commodities, Study Series No. 5, TARIFFS, TAXES AND ELECTRONIC COMMERCE: REVENUE IMPLICATIONS FOR DEVELOPING COUNTRIES, UNCTAD, Geneva - Switzerland,Nov.2000

[21] The EU has proposed that non-EU suppliers selling in the EU be required to apply taxes on the same basis as an EU operator when transacting business in the EU. In order to facilitate compliance, they propose that non-EU e-commerce operators be required to register in one EU member State and have the possibility of discharging all their obligations by dealing with a single tax administration (European Commission, 2000).

[22] Recent predictions give business-to-consumer e-commerce steep growth rates as well. According to Forrester Research, business-to-consumer e-commerce in the United States accounted for US$ 20 billion in 1999, and is expected to reach US$ 184 billion by 2004. Goldman-Sachs estimates that electronic shopping could account for 15-20 per cent by 2010 (The Economist, 2000b).

[23] European Commission, Directorate General XXI, Working Paper No. 1

[24] European Commission, Directive on VAT, June 7 2000

[25] Such as Republic Act No.8792 or E-Commerce Act 1999 of Philippine, Information technology Act 2000 of India, Digital Signature Act 1997of Malaysia, Singapore Electronic Transaction Act 1998.