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TAX IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE

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Declaration

I **Zukile Nomafu** declare that this research, unless specifically indicated to the contrary in the text, represents the original work by the author. It has not been submitted before, in part or in whole, for any degree or examination.



SIGNATURE

1. Abstract

Electronic commerce is a new technology, which is growing rapidly and has the ability to create a truly global digital economy. The extraordinary growth of the internet in the last few years has led to the birth of a world without borders, a place where free communication, a competitive market and extensive comparison shopping are a matter of course. This apparent lack of geography in cyberspace has raised complex problems regarding government tax policy. The rapid rise in sales over the internet and the fact that most internet buyers pay no income tax on transactions has ignited a considerable debate over taxes and the internet. The nature of the internet and the globalisation of the world economy mean that developments in e-commerce create legal problems concerning security of transactions and legal jurisdiction of transactions.

There is a general concern that e-commerce provides taxpayers with the ability to move transactions outside a country's jurisdiction and thus avoid paying tax in that taxing jurisdiction. The advent of e-commerce has also given dishonest taxpayers the ability to structure their affairs to reduce or avoid paying tax in their jurisdictions.

Rules written specifically to address the unique characteristics of electronic commerce are few and must be creatively adapted to the unique needs of e-commerce. As the volume of e-commerce increases, however, so will the number of rules. Many government committees and commissions devoted wholly or partly to make proposals and write the rules for e-commerce, exist throughout the world. In the United States the highest profile commission is the Advisory Commission on Electronic Commerce. This commission has a mandate to recommend far-reaching changes to the taxation of electronic commerce, especially in the areas of sales and value-added tax ('Vat') and cross-border taxation.

Research conducted by Austan Goolsbee has shown that applying the conventional tax policy to the internet commerce will reduce the number of buyers on the internet by up to 24 percent. Various countries are currently formulating their respective regulatory policies in an attempt to find solutions to problems posed by e-commerce.

Key Words: Bits, Bytes, Cyberspace, Digitised Goods, Electronic Commerce, Globalisation, Intellectual Property, Internet, Internet Tax Freedom Act, Internet Traffic, OECD, Online, Tax Treaties, Vat, Web-Server, Website.

2. Chapter One: Introduction

2.1 Background and development of e-commerce

According to Choi, Stahl and Whinston (1997) electronic commerce refers to the use of electronic means and technologies to conduct commerce, including within business to business and business to consumer relationships. It has become impossible to ignore the impact that the internet has on how business is conducted. New information and communications technologies such as the internet are creating exciting opportunities for workers, consumers and businesses.

The study conducted by the USA government revealed that the internet traffic is doubling every 100 days with over 100 million users currently online. It is also forecasted that revenues arising from internet transactions will grow from US$8bn to over US$300bn in the next five years. Michalski (1996) comments that businesses are compelled to use the internet for several reasons. Firstly the internet provides global access to large audiences at a relatively inexpensive price. Secondly, it offers unlimited real estate and the ability to connect with millions of users. Thirdly, it allows firms to have a virtual front door to a large audience through a website as well as creating useful interactions with customers and suppliers.

Companies are rapidly increasing their import and export of goods, services and information as the costs associated with participating in global markets fall. Internet commerce has touched all aspects of business eg. technology infrastructure, business to business trading, business to consumer trading, marketing and advertising strategies and interesting strategic alliances and partnerships. Consumers can now choose from a much broader range of goods and services from a wider network of suppliers. New technologies, particularly communication technologies including the Internet, have eliminated national borders. This has resulted in cross-border transactions and the companies run the risk that countries will claim inconsistent tax jurisdictions, and the taxpayer may be subject to double taxation. There may no longer be any geographic borders for electronic business, but tax still has to be collected by tax collection bodies that have a natural interest on how much tax is due to their jurisdictions.

In order to ensure that these new technology communications are not impeded, the tax policies to be developed should be guided by the principle of neutrality. This will ensure that economically similar transactions are treated equally irrespective of whether they are

electronic transactions or conventional business transactions. The major substantive issue raised by the internet is identifying the country or countries that have the jurisdiction to tax income arising from an internet transaction. It is highly important to clarify how existing tax policies apply to electronic commerce. Electronic commerce is likely to accelerate the current trend to move from source-based taxation to residence-based taxation. Another major category of issues involves the classification of income arising from transactions in digitized information such as computer programs, books and magazines.

As technology is changing consumer and business relationships, it also changes the nature of government's oversight of and intervention in those relationships. The most profound effect of this change is in the globalisation of commerce, which places national governments and international institutions in a quandary as to which jurisdictions, and hence which set of rules should be applied to which activities and by whom. It is therefore necessary to clarify how existing concepts apply to persons and companies engaged in e-commerce.

In the area of tax administration and compliance, electronic commerce may create new variations on old issues as well as new categories of issues. The major compliance issue posed by e-commerce is the extent to which electronic money is similar to cash and therefore creates the opportunity for anonymous and untraceable transactions. Another important issue involves identifying parties to the transaction utilising new technologies and verifying records when transactions are conducted electronically. It is hoped that developments in encryption and related technologies leads to systems that verify the identity of persons transacting online and ensure the authenticity of electronic documents.

The success of global e-commerce thus depends heavily on a worldwide harmonisation of certain basic policies in areas such as taxation and duties, as well as treatment of intellectual property rights and other trans-jurisdictional matters.

2.2 Tax implications of e-commerce

Globalisation has resulted in problematic consequences, one of which impacts on the collection of taxes. Electronic commerce is borderless and as a result, cross-boarder transactions may run the risk that countries will claim inconsistent taxing jurisdictions and that the taxpayer will be subject to impracticable taxation.

The introduction of electronic cash makes tax avoidance much easier. This technology allows the instant electronic transmission of cash from one bank account to the other, leaving no audit trail. This technology, combined with digital networks also makes it possible for businesses and individuals to open bank accounts abroad. The following factors highlight the tax implications of electronic commerce;

2.2.1 Central management and control

The global facilities provided by e-commerce are expected to allow residents to more easily influence the operations of their offshore associated companies. There is no clear guidance as to where such business would be regarded to be carried on. There would then be more difficulties in applying the concept of central management and control. There is sufficient authority to indicate that it is likely that the courts will modify the application of the central management and control test to accommodate the internet environment eg. video-conferencing.

2.2.2 Controlled Foreign Corporations ("CFC")

The potential escalation in the involvement in CFC's by individuals and small businesses may test the taxing jurisdictions ability to enforce the CFC provisions as use of the internet to acquire shares will make it difficult to trace share holdings and levels of control. Many digital products falling within the current broad definition of royalties may escape the CFC provisions if they satisfy the exclusion tests for tainted royalty income. Given the flexible nature of digital products and the scope for decentralised product development, some taxpayers may attempt to establish that a product was developed or substantially altered in an offshore company. The operation of the current CFC, management and control and general anti avoidance provisions need to be examined to ensure that residents are not able to establish the appearance of an offshore internet business to keep their profits in low tax jurisdictions.

2.2.3 Characterisation of income

In most tax jurisdictions, it is important to distinguish between the sale of tangible goods, the provision of services and the use of intangible assets as such classification determines where and how a sale should be taxed. The taxation of a sale of goods may

depend on where the contract was concluded or where payment was made. Services are normally taxed where the service was actually performed while the use of intangible assets results in a royalty payment that may be subject to withholding taxes.

Electronic commerce has transformed products that were previously supplied in the form of tangible property into digital form. Customers can now download books and compact disks electronically. Under the conventional channels of distribution, the resident country would receive tax revenues from the sale of such goods. If access to goods online is still regarded as a sale of goods for tax purposes, the sale has been achieved without any local distribution infrastructure. The question then would be whether the sale through conventional means and an internet sale can be treated similarly.

2.2.4 Residence and source

Most countries tax worldwide income of residents and income sourced in that country by non-residents. Double taxation is avoided through double tax agreements whereby the resident country gives tax credit for foreign income taxed by foreign countries. The sale of goods online has the potential to reduce source-based taxation.

When determining the source of income from the sale of goods or provision of professional services, a relevant factor is the application of contract law to internet transactions, which can be easily manipulated for tax purposes. Some particular difficulties are:

- The application of the contract of law to internet transactions requires an analysis of each web site that is doing business in that jurisdiction, and this will be difficult to do; and

- The extent to which the court would look through a web site to the real location of the seller. Applying source rules to internet sales will often be complex and involve information that is not always available.

2.2.5 Share trading income

E-commerce will open share trading to a wide range of resident individual and small business traders who could be difficult to locate, less likely to keep records and may not fully apply contract principles to determine where the contract was concluded for purposes of determining the source of income. A large number of transactions may not occur in the normal market and the existence of transactions and identities of parties to the transaction will be more difficult to determine.

The USA Treasury has determined that the residence based principle of taxation should prevail over the source principle. Although residence is mostly defined by reference to the place of incorporation, many tax jurisdictions refer to management and control. As most countries permit foreign nationals to be directors of local companies and allow board meetings to be held outside the home territory, videoconferencing increases the likelihood that management and control will be exercised in multiple locations or no location at all.

The increasing ease with which business activities can be moved will make it easier for businesses to choose where to be located and where to be taxed. This will probably lead to migration of business activity to tax havens. A number of tax havens are already promoting themselves as ideal locations for computer services and related electronic commerce trading.

2.2.6 Permanent establishment ("PE")

A permanent establishment is a fixed place of business through which the business of an enterprise is conducted. The creation of a permanent establishment normally entails both a physical and human presence. E-commerce raises a question as to whether a non-resident vendor will have a permanent establishment as a result of sale activities generated through a website held on a local computer server. The physical location of a computer server rarely constitutes a permanent establishment and if it were held to be a permanent establishment, this will lead to a migration of such equipment to low tax jurisdictions. This may result in loss of income from high tax jurisdictions. If websites constitute a PE, the attribution of income to such a PE would require a

consideration of economic substance, but there is no internationally agreed upon approach on how attribution of income to a web site should be done.

Apart from the question of physical presence, there is an issue of the activities of the agents. Most countries have a common view that the internet service providers fall within the definition of independent agents. The fact that contracts are negotiated and concluded through the independent service provider infrastructure does not necessarily make the service provider an independent agent in relation to that activity.

2.2.7 Transfer pricing

E-commerce does not present new problems for transfer pricing other than that value added activities that were previously undertaken by people are being replaced by software and machinery. This results in increased sharing of central services and business development activity by multinationals. They key issues arising out of internet trading are:

- Tax administrations will have to evaluate the effects of intangible assets more often;
- The lack of reliable data will make the transactional approach and the establishment of comparability more difficult to apply;
- Difficulties in obtaining pertinent data located outside the jurisdiction;
- Difficulty in identifying that the transaction occurred between parties;
- Difficulty in valuing the contributions of related parties or parts of the same entity where businesses become highly integrated; and
- Increasing numbers of cases highlighting the differing tax treatment between permanent establishments and subsidiaries carrying on economically similar activities.

The speed, frequency, anonymity and integration of exchanges over the internet will place pressure on the transactional methodologies and comparability principles. It may therefore be more difficult for tax administrators to identify, trace and qualify cross border transactions. There is debate as to whether the use of the profit-split method is required where external comparable data are more difficult to identify. This approach is likely to be extended to a number of other electronic commerce transactions.

2.2.8 Witholding taxes

E-commerce opens up borrowing facilities to a large number of domestic consumers whom a tax deduction for the payment may not be available. In most cases, payments of royalties by individual consumers will involve a large number of low value transactions in respect of which witholding obligations may prove difficult to enforce as there is potential loss of third party institutional intermediaries that traditionally served as collection points.

2.3 Aspects of e-commerce

The six unique aspects of electronic commerce are as follows:

(1) Worldwide Sales

Historically, geography has been the barrier to entry in multi-state and multinational markets. A company seeking to sell to customers in another country had to make significant efforts and expend significant resources in both advertising and transacting business to be successful in non-local markets. E-commerce allows for the existence of a new type of a company, the small-multinational. Anyone with little capital and a good idea can open a store on the internet and thereby gain immediate access to consumers all over the world.

(2) Remote operation of a Web-Server

One fascinating aspect of e-commerce is the ability to operate a remote web-server. A website and the web-server can be located anywhere without affecting the operation of the website. Many companies do not have sufficient in-house expertise to host the web-server and elect to share a web-server operated by an independent hosting company. Other companies choose to use remote web-servers for the tax advantages they may offer as the web-server can result in the avoidance of tax in a company's home country.

(3) Anonymity

Anonymity of parties to an e-commerce transaction impacts taxes in two ways. Firstly the vendors that know little or nothing about their buyers find it difficult to comply with tax filing requirements. Secondly, some vendors will take advantage of anonymous buyers and untraceable electronic cash to evade tax. This is especially true where the vendor sells digital products or services and does not need buyer information to complete a transaction.

(4) Digital Products

The notion of selling digital products in unique to e-commerce. The most commonly sold digital products are software downloaded from the internet. The difficult issue regarding these transactions is the fact that there is little agreement on the character of these products. In international taxation, the characterisation of sales is important as these products may be classified as product sales income, royalties, services or the sale of intangibles. The classification will determine the country where the sales are taxable.

(5) Intangibles

Many electronic commerce enterprises are made up of software, data and good ideas. In December 1998, the market value of American Online's stock was over US$70 billion. However, the balance sheet showed very little hard assets and most of its value was attributed to primary data and intangible assets. Tax accounting of websites development costs, and taxation of purchases and sales of e-commerce companies depends largely on the tax rules relating to intangible assets.

(6) Changing rules

Rules written specifically to address the unique feature of electronic commerce are few. Most countries believe that existing rules should be adopted to cater for the challenges posed by e-commerce but no new rules should be developed. Many organisations exist throughout the world to recommend changes to be made to existing rules and if deemed necessary, to develop new rules.

3. Chapter Two: Research Methodology

3.1 Objectives of the research

This research report seeks to provide an introduction to certain income tax policy and administration issues presented by developments in electronic commerce and will also elicit views on the issues presented as well as suggested solutions to some of these problems.

3.2 Statement of the problem

The rapid growth of on-line ordering and delivery poses major problems to governments in their efforts to collect taxes. The problems is that a business can engage in e-commerce without having a physical presence. The "virtual corporations" that exist today are way beyond what was imagined during the formative stages of present day tax laws. The internet has effectively eliminated national boarders and as a result, cross-boarder transactions run the risk that countries will claim inconsistent taxing jurisdictions and that the taxpayer will be subject to impracticable taxation. Various government authorities are making efforts to ensure that tax law does not lag too far behind the development in commercial practices.

Several key issues remain unresolved and whilst they represent problems for the authorities, they also present opportunities for legitimate tax planning so that businesses can reduce their tax payments in some countries in which they operate. Businesses face risks in the tax treatment of their methods and structures. This is partly due to uncertainty in the application of old principle to new technology and the fact that the principles were never designed to deal with all modern situations for example:

- a company might place a server in a foreign country and this might lead to overseas tax being chargeable if the server is capable of processing orders and effecting delivery of goods; and

- Businesses might not be complying with Vat in that they are required to be registered for Vat in countries where they have no presence.

Many countries have enacted tax treaties with other countries that follow the tax models developed by the Organisation for Economic Cooperation and Development ("OECD"). As e-commerce has grown, the OECD has been in the forefront of developing tax models to deal with it. Countries that are outside the OECD are now joining the OECD to find practical solutions. The main tax problems posed by the explosion of e-commerce are:

Basis of charge:	most countries' tax systems have a combination of charges that relate to the profits earned by the business that resides within their jurisdiction and to the place at which goods and services are delivered. E-commerce is generally not tied to a location.
Anonymity:	it is difficult to identify the parties to an e-commerce transaction at all times. If data transfers were encrypted, then tracing transactions becomes almost impossible and in any event involve significant time and costs. It is not always possible to know the name and location of the seller or buyer in an Internet transaction.
Definition of transaction:	if data is transferred over the Internet, how should that transaction be classified? Possibilities include treating it as a service, a granting of goods or the granting of licence for use.
Compliance:	it is generally the suppliers of goods and services that ensure that Vat is collected on relevant transactions. It is clear that a substantial burden could fall on suppliers as they try to fulfill their obligation to verify the nature of each transaction and the location of their customers.
Enforcement:	the enforcement of tax systems requires the presence in a country of a representative of the taxpayer. At present there is little or no effective way that a foreign jurisdiction will enforce another country's tax regime.

3.3 Importance of research

This paper attempts to highlight the problems of legislating e-commerce. Some of the issues raised in this paper can be resolved through administrative process while others can be resolved through amendments to the income tax policies and regulations. This report highlights the problems faced by various taxing jurisdictions with regards to regulating e-commerce

transactions, as this form of transacting has the potential to erode the various countries' tax bases.

3.4 Methodology

A literature review was conducted leading to a descriptive exposure of work undertaken by various countries in addressing the tax effects of electronic commerce. A detailed analysis of principles and policies adopted by the United States of America, Australia, United Kingdom, OECD, European Commission and South Africa, together with their shortcomings, was conducted. The literature review comprised a review of information obtained from industry journals, professional reports and reports from various international organizations and commissions.

3.5 Limitations

The research report is limited to a review and analysis of the tax implications of electronic commerce. This paper is not intended to resolve all the tax policy and administration issues posed by e-commerce, but is intended to identify and assess some of these issues. Most of the literature reviewed was from international sources as I believe that South Africa should draw international experience in formulating its electronic tax policies.

4. Chapter Three: Literature review

4.1 International perspective

4.1.1 The United States of America ("USA")

The USA taxes income on the bases of both the source of the income and the residence of the person earning such income. USA source income is subject to tax when earned by foreign persons as is the worldwide income of USA citizens, residents and corporations. The USA has the highest instance of electronic commerce transactions, but the legal issues are far from being resolved. The 'Framework for Global Electronic Commerce' outlines the USA Government's plans for assisting the growth of electronic commerce. The document takes the popular view that government should avoid regulation where possible and allow the private sector to initiate. The report, however, advocates the creation of a commercial code setting down basic rules for transactions over the internet and providing a means for governmental recognition of electronic contracts, mutual recognition of signatures and dispute settlement. The USA has already begun adapting the Uniform Commercial Code, which governs USA commercial law for this purpose.

The growth of new communications technologies and electronic commerce further strengthens the importance of the principles of residence-based taxation as it is difficult to apply traditional source concepts to link an item of income with a specific geographic location. Therefore, the source-based system of taxation would lose its rationale and can be rendered obsolete by electronic commerce. As all taxpayers are always residents of at least one country, it will only be fair that they should be taxed in those countries. Although most countries, including South Africa, are changing to the residence-based system of taxation, a review of current residency definitions and taxation rules may be appropriate.

The general approach taken by the USA is to tax internet-based transactions under the existing rules. This therefore means that conventional and internet based transactions are taxed in the same way. The key principle for future policy, according to the Internet Freedom Act, is neutrality. The same transactions carried out using the

internet and through conventional means should be taxed the same. A non-USA company is taxable in the USA if the following two conditions are met:

- The company is a resident of a country with which the USA has a tax treaty and the company has a permanent establishment in the USA. This effectively means that the company must have a place of business in the USA or must have an agent in the USA. If the country does not have a treaty with the USA, sales are taxable if the sales are effectively connected with the conduct of a USA trade or business; and

- The income received by the company is non-business income eg. royalties and rental income.

To the extent that a foreign person is not engaged in a USA trade or business, the absence of a permanent establishment is irrelevant since the USA will not tax that person's active business income. USA permanent establishment rules generally require a fixed place of business in the USA although a permanent establishment can also arise by imputation from the activities of an agent. Therefore, persons engaged in electronic commerce may not have a USA permanent establishment because they do not have a fixed place of business in the USA, unless a permanent establishment is created by imputation from an agent's activities.

In the case of electronic commerce, the agency issues arise from the relationship between foreign person and a computer online service or telecommunications service provider. Even if the person engaged in electronic commerce does not maintain a computer server in the USA, issues of USA trade or permanent establishment may arise, e.g a USA customer might access the foreign information seller's website using a USA-based internet service provider. In this example, the service provider would not be classified as an agent. Even if the agency relationship was deemed to exist, the service provider would likely be considered an independent agent and a permanent establishment would not exist. It may be further necessary to clarify the applicable principles in this area and seek to create an international consensus on this issue.

The principles used to determine whether a person is engaged in USA trade or maintain a USA permanent establishment might differ if the person is primarily engaged

in providing telecommunication services as opposed to a business which is primarily engaged in selling goods or services for whom the telecommunication services are merely incidental. In the case of foreign telecommunication service provider, the operation of a computer server in the USA or the sale of computing services and internet access to the USA and foreign customers is integral to the realisation of profits, as opposed to the case of a foreign person who is primarily engaged in selling data which is stored on a USA based server.

Issues and recommendations

(1) Classification of transactions and income from digitised products

Any type of information that can be digitised, such as computer programs, books or music can be transferred electronically. The purchase of these products could obtain the right to use a single copy of the image or the right to reproduce several copies of the images. Depending on the facts and circumstances, these transactions may be viewed as the equivalent of the purchase of a physical copy of the image, which would probably not subject the seller to USA taxation, while it may also result in royalty income because they involve payment for the use or the privilege of using copyrights or similar property in the USA, which could be taxable in the USA. Information that can be digitised is normally protected by copyright laws and payment for the use of the privilege is considered a royalty. It is not always clear how this definition applies to the sale of digitised information since some of these transactions are mere substitutes for conventional transactions involving physical objects.

The proposed regulations on the classification of income from transactions involving computer programs represent an initial attempt to resolve these issues. The proposed regulations treat transactions involving computer programs as being either;

- transfers of copyright rights;
- transfers of copies of the copyrighted program;
- the provision of services for the development or modification of a computer program; or

- the provision of know-how regarding computer programming techniques.

The primary distinction established by the proposed regulations is between transfers of copyright rights and transfers of copyrighted articles. The proposed regulations use copyright law principles to determine whether the rights transferred are rights in the underlying copyright law or rights in copyrighted work. However, the proposed regulations depart from copyright law when appropriate to take into account the special characteristics of computer programs.

The law principles are then applied to determine whether or not there has been a partial or complete transfer of these rights, which will determine the tax classification of the resulting income for example, computer programs are frequently distributed through site licences. Under the site licence, a licencee might obtain only one disk containing the program but also obtains the right to make a certain number of copies for internal use. Notwithstanding the term applied to the transaction or the grant of a copyright right under USA copyright law, the regulation proposes to treat this transaction as a sale of goods for tax purposes.

In the South Central Bell Telephone v. Barthelemy, 643 Wso.@d 1240 (La.1994) case, the Louisiana court held that both custom and non-custom software, whether transferred by disk or by modem, was tangible personal property and subject to sales tax and Vat in New Orleans. Support for this conclusion was that software constitutes goods and software and is part of the physical word. The court further stated that the objective of the transaction was to obtain recorded knowledge stored in some sort of physical form that a computer could use and that the software recorded in physical form becomes inextricably intertwined with the corporeal object upon which it is recorded.

The Louisiana Dept. of Revenue and Taxation subsequently changed its sales tax rule to eliminate the prior language that only canned software was tangible property. Thus all software is now subject to sales tax and Vat regardless of its function or how it was transferred. However, specific separately stated and

commercially severable charges for technical services, such as training and consultation will not be subject to sales tax.

In contrast, in Dept. of Revenue, State of Florida v. Quotron Systems, Inc., 615 So.2d 774 (Fl.1993), the Florida Department of Revenue assessed Quotron approximately US$3.8 million for unpaid sales tax, interest and penalties for 4 years. Quotron, in the business of transmitting financial data to customers including banks and brokerage houses, only sold data by electronic means. If a customer printed the data, there was no additional charge and Quotron would not know of the printing. Customers had only access to the video display terminal, not to Quotron's central processing unit. Quotron charged only for the use of the data. A customer using its own display terminals would pay similarly to one who used Quotron's terminals. The Dept of Revenue argued that Quotron owed sales tax on its transmission of electronic data because transmission of images was a sale of tangible personal property and such images were perceptible to the senses. The court disagreed and held that Quotron was not liable for sales tax. The court noted that the images on the screen were not capable of being either touched or possessed because they were only of a transient nature. Thus, the court could not find that the images were tangible personal property subject to sales tax.

(2) Effect on controlled foreign corporation rules

The ability of taxpayers to electronically sell digitised information and services may have an effect on existing rules regarding the controlled foreign corporations. If controlled foreign corporations engage in extensive commerce in information and services through websites or computer networks located in tax havens, it may become increasingly difficult to enforce current legislation and this presents enforcement problems because it may be difficult to verify the identity of the taxpayer to whom foreign base company sales income accrues and the amount of such income.

(3) Source of service income

Income derived from the performance of personal services only constitutes USA source income if the person performing the services is physically present in the USA. This principle is based on the view that an independent agent has substantial significance to the location where the person rendering the services is located with the result that it is reasonable for that country to tax such services. As travel and communications have become more efficient and less expensive, the relationship between the service provider's location and the consumer's location has weakened as telecommunications and videoconferencing have eliminated the need for face to face meetings.

(4) The Internet Tax Freedom Act ("the Act')

The Act did not provide the guidance and regulation of e-commerce. It bans 'bit taxes', taxes measured by the volume of digital information transmitted electronically. The Act prevents states from imposing new sales taxes or fees on internet access, but leaves such taxes in states where they are already imposed. It also prevents discriminatory taxes on internet-based transactions.

The major recommendation by the Act was the creation of a committee to consider future rules for electronic commerce, hence the Advisory Commission of Electronic Commerce was established.

The growth of electronic commerce led the USA congress to pass the Internet Tax Freedom Act in Oct. 1998. The main provisions of the act are as follows:

- Three-year moratorium on special taxation of the internet. This prohibits the taxation of internet service providers unless it can be demonstrated that these taxes had already been generally imposed and enforced on the internet service provider prior to October 1, 1998;

- Three-year moratorium on discriminatory taxes on electronic commerce transactions. This provision makes it illegal for the state to impose taxes that would subject the parties to the internet transaction to taxation in multiple states and also protects against the imposition of new tax liabilities including the application of discriminatory taxes; and

- Internet commerce should be tariff-free. This ensures that e-commerce continues to be free of tariffs and other taxes imposed on international tax jurisdictions.

The Advisory Commission on Electronic Commerce has made the following recommendations to the USA Congress:

1. Sales and use taxes

The current moratorium barring multiple and discriminatory taxation of sales of digitised goods and products should be extended for a period of five years ending 2005.The commission has clarified that the following factors would not establish a seller's physical presence in a state for purposes of determining whether a seller has sufficient permanent establishment with the state to impose collection obligations:

(i) a seller's use of an internet service provider that has physical presence in a state;
(ii) the placement of a seller's digital data on a server located in that particular state;
(iii) a seller's use of telecommunications services provided by a telecommunication provider that has physical presence in a state;
(iv) a seller's ownership of intangible property that is used or is present in that state;
(v) the presence of the seller's customers in that state;

(vi) a seller's affiliation with another taxpayer that has physical presence in that state;

(vii) the performance of repair or warranty services with respect to property sold by a seller that does not otherwise have a physical presence in that state;

(viii) a contractual relationship between seller and another party located within the state that permits goods or products purchased through the seller's website or catalogue to be returned to the other party's location within that state; and

(ix) the advertisement of a seller's business location, telephone number, and web site address.

2. Business Activity Taxes

The following factors will not be taken into account in determining whether the seller has sufficient jurisdiction with a state to be required to meet business activity and income tax obligations:

(i) a seller's use of an internet service provider that has physical presence in a state;

(ii) the placement of a seller's digital data on a server located in that particular state;

(iii) a seller's use of telecommunications services provided by the telecommunications provider that has physical presence in that state;

(iv) a seller's ownership of intangible property that is used or is present in that state;

(v) the presence of a seller's customers in a state;

(vi) a seller's affiliation with another taxpayer that has physical presence in that state;

(vii) the performance of repair or warranty services with respect to property sold by a seller that does not otherwise have physical presence in that state; and

(viii) the advertisement of a seller's business location, telephone number and web site address.

3. Tariffs

The imposition of tariffs on electronic transmissions presents a unique situation. Electronic transmissions consisting of bits and bytes, zero's and ones encompass international data flows and the content embedded in that data. Unlike physically transported goods, the bits and bytes of an electronic transmission are not readily identifiable and do not stop at the border and hence make imposition of tariffs impossible. Over the last 50 years, the USA's policy has been to use international mechanisms to progressively lower duties and eliminate trade distortions. The USA has been at the forefront to promote a moratorium on the imposition of customs duties on e-commerce transactions. The USA believes that tariffs negatively impact on all customers around the world and inhibits free trade amongst nations and countries.

As there are currently no customs duties on electronic transactions, the USA and Japan are working towards a global understanding that this duty free should remain. These countries have welcomed the announcement by the Quad Ministers to work toward a comprehensive work program in the World Trade Organisation on the trade-related aspects of electronic commerce, and both nations will actively participate in this process.

4. International taxes on goods and services

The USA has recognised the OECD's leadership role in coordinating international dialogue concerning the taxation of e-commerce and supports the principles for taxation of e-commerce and the OECD's role as the appropriate forum for fostering effective international dialogues concerning these issues and building international consensus on the following principles:

(i) no new taxes should be applied to e-commerce, rather existing taxation principles should be applied and if deemed necessary, internationally accepted rules of taxation should be clarified to accommodate changing forms of business activity;

(ii) any taxation of e-commerce transactions should not distort or prohibit trade and any clarification or modifications to existing rules should not discriminate against e-commerce;

(iii) any tax system imposed on e-commerce should be simple and transparent and;

(iv) any modifications to existing rules or adoption of new rules should be made in consultation with the business community and other affected parties and all nations should be encouraged to postpone modification of their tax systems in order to allow for the developments of an international consensus.

The Commission met for the final time in March 2000 but failed to reach the broad consensus required. The recommendations of their report that were not adopted by the commission as the required majority could not be achieved include the following:

(i) repealing the 3% federal excise tax on telecommunications services;

(ii) permanently barring states and local tax jurisdictions from taxing internet access fees;

(iii) encouraging states to find a more simplified state sales and use taxation system;

(iv) extending the moratorium on multiple and discriminatory taxes until 2006; and

(v) halting international tariffs on internet transactions.

4.1.2 United Kingdom

The United Kingdom ('UK') believes that the principles that should guide tax laws relating to e-commerce should include certainty in tax law, neutrality, prevention of double taxation, low compliance costs and no new taxes on internet based commerce.

The UK does not believe it is necessary, at this stage, to make major changes to existing tax legislation and regulation or to introduce new taxes. At the same time it recognizes the aspects of e-commerce mentioned above and that they must be addressed. Various initiatives have been undertaken to deal with these aspects.

Combating tax avoidance and evasion

The UK is concerned about the potential for tax avoidance and tax evasion by persons engaged in e-commerce. This is especially true for businesses selling digital products especially downloading recorded music and videos. The UK acknowledges that where a company sells products to anonymous buyers using untraceable electronic cash, where the company can be run remotely from an offshore tax haven, and where it is impossible to audit sales, tax evasion will be too easy. As evidence of tax evasion mounts, it is expected that the UK Inland Revenue Services ('IRS') will recommend aggressive procedures to track noncompliance. However, these procedures will likely have the effect of reducing privacy in e-commerce transactions.

Cross-border transactions involving digital products

Resolving the problem with differentiating whether payments related to the acquisition or use of digital products are characterized as royalty payments or payments for the purchase of products needs to be resolved since royalty payments are generally subject to withholding taxes at source, while payments for products are not. The IRS's position of software transactions is that the way in which a software product is transferred has no impact on its taxability. The focus is on the rights transferred as the primary determinant of the nature of a transaction as taxpayers can change the form of delivery to change the tax result.

The IRS is considering extending these rules to other digital products eg. electronically transferred music, videos and books.

Effect of a web-server location in cross-border transactions

The UK acknowledges that the use of permanent establishment as a threshold for taxation is a long-standing and widely supported one and the IRS does not intend to

depart from it. However, whether a web server located in a country results in a permanent establishment is not clear and the UK is working with the OECD to update commentary in the OECD Model Tax Convention.

Value Added Tax

The UK does not see the need to change the rules related to physically delivered goods, where the internet is merely a means by which an order is placed. However, the services being performed, and the difficulties in imposing and collecting Vat are not substantially changed by electronic commerce. The expected increase in cross-border services that will result from e-commerce will exacerbate compliance problems inherent in collection of Vat on services.

Vat and Digital products

The UK and the European Union have rejected the idea of special taxes on internet transactions ('bit taxes') based on the following arguments:

(i) the bit tax triggers double taxation – communication activities on the internet are taxed in the same manner as other communication services. The bit tax leads to double taxation;

(ii) The bit tax would not solve the problems posed by e-commerce – electronic transactions raise issues relating to tracing transactions and relevant jurisdictions. These issues will not be resolved by merely charging bit taxes;

(iii) A tax on physical transactions is difficult to implement – 'physical' transactions refers to bit throughput as opposed to the actual value of transactions. The bits are difficult to count and could be hidden by encryption and counting bits will probably cost more than revenue generated;

(iv) The bit tax would inevitably produce inefficient distortions – since the internet offers new forms of goods and services with implicit quality differences, internet suppliers will most likely practice some type of price discrimination. Any taxation on the internet will induce distortions; and

(v) Taxation and the internet development problems – since Europe is lagging behind the USA in terms of internet development, the prospect of taxation is

considered inappropriate. In addition security issues should be addressed first before considering taxation problems.

Tax administration

The UK has taken various initiatives relating to improving efficiency and easing the tax burden of tax compliance including improvement of web sites, use of electronic signatures, electronic filing and direct deposits.

4.1.3 Australia

The Committee on Fiscal Affairs ('CFA') of the OECD has initiated intensive discussion on issues surrounding tax implications of electronic commerce and Australia, through the office of the Australian Tax Office ('ATO') has been a major player in those discussions.

Issues and recommendations

Sale of goods over the internet

Source of income is a fundamental concept in determining taxation jurisdictions. For non-residents, the source of income is important because they are generally taxed on income from sources in Australia. Under Australian income tax law, source of income is generally determined by reference to common law rules and in the case of trading profits, the source of income under common law is usually the place where the enterprise conducts its trading activities. In order to determine the source of trading profits, it is necessary to examine where the economic activity takes place. In Grainger and Son v. Gough 3 TC 462, the court found that in determining where trading activities are being conducted, it is important to have regard to the economic activity which gives rise to the profit, rather than the mere fact that goods are supplied to customers in a particular jurisdiction.

In the electronic commerce context, the determination of when an enterprise is trading within a jurisdiction is likely to be more difficult. One view is that the customer in accessing the enterprise website is coming to the website to purchase and that the

trading activities take place in the jurisdiction where the website is located. Another view is that when the customer accesses a website, all the relevant activities take place at the customer's computer and the trading activities could be said to occur in the jurisdiction where the customer is located.

Australian courts, in determining source of trading profits, have tendered to focus on where the selling activities of the enterprise take place. Where the activities of the trader that give rise to the sales profits are effectively conducted through a website, the relevant activity of the enterprise is the operation of the software which constitutes the website. Since these activities are conducted by the enterprise on the server where the software is located, and in the absence of any value-adding activity performed by the trader in the jurisdiction of the customer, a court may find that that the trading activities are conducted at the location of the server where the website is situated. If this view is correct, an enterprise would not be considered to be trading in Australia because it operates a website that is accessible by Australian residents, from which those residents can purchase goods.

It appears that a non-resident who sells goods through a website located in a server in Australia, and who maintains a store of goods in Australia for delivery, could be considered to be carrying on trading activities in Australia, with the result that the profits from the sales would have an Australian source.

Place of contract of sale

Another issue in determining the source of trading profits is the place where the contract of sale is made. Where the sale of goods involves only acquiring and selling the goods without processing them, the place where the contract for the sale of the goods is negotiated and concluded will often be a significant factor in determining the source of the profits on the sale. In Federal Commissioner of Taxation v. W. Angliss & Co (1931) 46 CLR 417, Dixon J, the court found that the place of acquisition usually has little relevance, although this is not entirely settled if, for example, the goods are bought below the price ruling at the time of shipment. The fact that a contract for sale is concluded outside Australia is not always decisive in providing a foreign source. In some instances, the place of payment or where the goods are delivered may be material considerations.

In Pharmaceutical Society of Great Britain v. Boots Cash Chemists (1953) 1 QB 401, the Australian court found that a party making an advertisement does not intend to enter a legally binding relationship with each and every person who purports to accept the advertisement. Based on this common law rule, it can be concluded that in an internet sale, the place of contract is the location where the offerer received notification of acceptance. Thus, where a customer in Australia e-mails an offer to purchase to an offshore seller, and the offshore seller e-mails acceptance to the customer, it is arguable that the contract is formed a the location of the customer at the time of accessing the e-mail message.

However, for tax law purposes, the place where the contract is made, it is not necessarily a determining factor for the source of income. In Thorpe Nominees (Pty) Ltd v. FC of T88 ATC 4886, it was found that the execution of agreements in Switzerland did not locate the source of income in Switzerland when the agreements were part of a scheme to avoid income tax. The real source of income was held to be in Australia, as the agreements related to the sale of rights in respect to options to purchase land in Australia, the options were exercised in Australia and the consideration for the sale of the nominated rights was received in Australia. It then follows that if the customer happened to access the acceptance message on a portable computer while holidaying in Mauritius, it can be argued that the place of contract is Mauritius. Another view may be that the place of contract should not be a dominant factor in determining source of sales income if all the negotiations were undertaken in Australia and the customer's business was in Australia.

Services provided over the internet

In Australian Machinery & Investment Co Ltd v Deputy Commissioner of Tax (WA) (1946) 3 AITR 359, the court found that the source of income derived from the provision of services will be the place where those services were performed. However, in Federal Commissioner of Taxation v. Mitchum (1965) 9 AITR 559, the court found that there is no rule of law in Australia that requires a conclusion that the source of income received for services rendered is in the place where the services are performed but that, with other forms of income, the source of services income is a question of fact, and that the source may have several factors. The courts have

identified three factors which may be relevant in determing source of income from services, namely:

- The place where the relevant contract is negotiated and made;
- The place where the services are performed; and
- The place where the remuneration is payable.

Where services are provided over the internet, the identification of the place where some or all of these factors occur may be difficult. It is arguable that in cases where the result of the performance of the services is more important that the location at which the services are actually performed, other factors such as the place of contract, or the place of payment, or the place where the services are utilised, should assume more importance in determining the source of income. This therefore means that if an Austalian resident enters into a contract for the provision of certain accounting services from an enterprise which operates an internet business to provide such services, the place or places where those services are performed may be of less important in determining the source than the place where the contract is negotiated and where the payments are made.

In some jurisdictions, the place of residence of the payer of income for services rendered may be regarded as the source of such income. However, it would seem unlikely that the courts in Australia would adopt this approach. Unless the income is derived from property used in Australia or from acts done in Australia there would seem to be little likelihood that an Australian court would find that the source of the income was in Australia.

Characterisation of income

Payments arising from digital products and delivery mechanisms used in e-commerce do not easily fall within traditional taxation characterisation. The magnitude of activities that can be created using digital technology and delivery mechanisms may lead to compliance and administration difficulties in apportioning between services, sales and royalties. The tax authorities around the world are examining possible approaches to the application of the existing definitions.

One approach under consideration by the ATO is to see whether the principles adopted in relation to the tax treatment of payments for computer software are relevant to transactions in digital products. The analysis in Taxation Ruling 93/2 of the ATO is that payments made for the right to do any of the acts comprised in the copyright come within paragraph (a) of the definition of royalty, being amounts paid as consideration for the use of, or the right to use, copyright in the computer payment. However, payments for right in the tangible article, or for rights to use the program are not royalties. The amounts attributable to the right to load a program onto the user's computer or computers would be a royalty.

The characterisation of income from transactions in digital products requires further consideration by both the ATO and other international jurisdictions and commissions.

Taxation of business profits under double tax agreements ('DTA')

Australia's right to tax business profits derived by non-residents in Australia is commonly governed by the bilateral DTA's to which Australia is a party. The business profits article of the Australia's DTA provides that business profits derived by an enterprise that is a resident of one country may be taxed only in that country unless the enterprise carries on business at or through a PE in the other country. Thus, the PE concept is central to the allocation of taxing rights over business profits between jurisdictions under a DTA.

Where the business of a non-resident enterprise includes activities conducted wholly or partly via the internet, in many cases there will be little difficulty in determining whether or not a PE exists. As with traditional forms of commerce, if the enterprise maintains a physical presence such as a branch or an office in Australia through which it conducts its business, then there will be a PE in Australia, and the profits attributable to the activities carried on through that PE, including activities conducted electronically, will be taxable in Australia.

Effect of website

Australia's DTA's largely follow the OECD Model Tax Convention definition of permanent establishment. Discussed below are the relevant paragraphs of the PE definition as they apply to the Australian context:

Fixed Place of Business

In the commentary to the OECD model, a fixed place of business contains the following three conditions:

- The existence of a place of business;
- The place of business must be fixed in terms of a distinct place and a certain degree of permanence; and
- Business is carried on through this fixed place of business

In the electronic commerce environment, physical presence may be replaced by an electronic presence such as a website. Where the website is located on a server within a jurisdiction, the question arises whether the website constitutes a place of business. In determining whether a server may be a PE, the Working Party I on Tax Conventions and Ralated Questions suggested that the server through which the website is operated is a piece of equipment and may thus constitute a fixed place of business of the enterprise that operates it. In Australia many of the DTA's specifically deem the use of substantial equipment to constitute a PE. It would follow that a server operated by an enterprise would qualify as equipment through which the business of the enterprise is carried on.

While it is arguable that under the existing definition of PE in Australia's DTA's, a website or server may constitute a PE, it appears that the existing definition will be difficult to apply in practice. These difficulties are compounded by the fact that there is scope for an internet business to structure its affairs to ensure they do or do not result in a PE being established in the source country. The physical location of a website or server is becoming irrelevant as a bandwidth. The tax planning opportunities are far from desirable, particularly if different countries take different

approaches in relation to whether websites or servers can constitute a PE. If within the OECD it becomes generally accepted that a website is not a PE, a number of the jurisdictional complexities and planning opportunities become less relevant.

Sale of goods where there is a DTA

The internet will increasingly enable a number of businesses to sell goods to Australian customers from outside Australia through a website located in Australia. Where the goods are delivered directly to the customers from abroad, the business profits article of Austalia's DTA would provide that the profits are not taxable in Australia. The businesses selling physical goods using warehouse facilities or maintaining stores of goods in Australia for delivery to Australian customers will not have a PE is Australia if these facilities are merely preparatory or auxiliary activities. However, there is strong argument that in an internet business where most of its activities are automated, delivery of goods should not be considered auxiliary or preparatory.

Sale of share, options, futures and other financial instruments where there is a DTA

Under the DTA, profits arising from sale of shares would generally fall under the business profits article and would be taxable only in the share trader's country of residence unless the profits are attributable to a PE of the share trader in the other country. Thus where a DTA applies, profits derived by a non-resident from trading in Australian shares via the internet, will not give rise to an Australian tax liability.

The provision of services where there is a DTA

Where a DTA operates, income from the provision of professional services would generally be dealt with under the independent personal services article. In Case 23 93 ATC 288, a New Zealand share trader operating through an Australian share dealer was held to have a PE in Australia because the dealer was not a broker, but an employee of a broker, and the dealer was not independent because he acted exclusively for the trader and in close consultation with him.

Many services that have traditionally required the physical presence of the service provider may now be provided remotely, including via the internet. Consequently, a significant increased number of services can be provided within a jurisdiction by non-residents, without the need for those service providers to establish a fixed based within that jurisdiction.

Income from services exercised by individuals in the course of employment would generally be dealt with under the dependent personal services article that provides exclusive taxing rights to the resident country except where the employment is exercised in the other treaty country. Employment is considered to be exercised in the place where the employee is physically present when performing the activities for which the employment income is paid. Under the DTA, income arising from services other than independent or dependent personal services would be dealt with under the business profits article, where the service provider is not a resident only being able to tax income attributable to a PE in that country.

The main impact of the internet in the DTA context will be to facilitate the provision of services to residents of another country without the need for a fixed base or PE.

Indirect Taxes

Since the release of the Tax and Internet Discussion report in 1999, legislation has been enacted to replace the Wholesale Sales Tax system with a Goods and Services Tax (GST), effective from 1 July 2000. For supplies occuring wholly within Australia, the GST legislation does not differentiate between business conducted electronically and conventional business. The principal challenge to the GST posed by electronic commerce is in the area of supplies from off-shore countries to Australia. The application of the GST to cross border electronic commerce transactions can be classified in these three broad categories:

1. Supplies of physical goods to both business and private consumers

   These supplies are identified in the same manner as physical goods, with imports subject to tax at the border. The method of ordering e.g electronic,

phone or mail, is irrelevant in terms of the application of taxation requirements.

2. Supplies from business to business of services or intangible products

   These supplies are dealt with by the reverse charge mechanism, whereby GST-registered businesses receiving such supplies from off-shore are required to self-assess their GST liability, only if they would be entitled to full input tax credit on the supply. GST free provisions apply to certain supplies for consumption outside Australia.

3. Supplies from business to private consumers of services and intangible products

   Up to now, no revenue authority has found a practical method for collecting consumption taxes on these supplies, and the Australia's GST does not seek to do so. While small in volume and amounts, these supplies potentially pose the most significant problem to the effective administration of consumption taxes, and is the focus of international attention.

The GST Act reflects the recommendations of the OECD in that in principle the Australian GST legislation seeks to tax consumption in Australia and that the legislation includes a definition of goods as intangible personal property. Digital information is not tangible personal property and is therefore not classified as goods.

Other recommendations

1. The ATO should establish policies associated with e-commerce in co-operation with other relevant federal government agencies. The lack of a legal infrastructure, until resolved, is likely to be an impediment to electronic commerce. However, since many issues that are of interest to the ATO are also of relevance to other governments, it is desirable that a co-operative approach be taken to policy development;

2. Australia should continue its role in having taxation and internet issues debated and where possible addressed in international forums, in particular the OECD, Pacific Association of Tax Administrators and Study Group on Asian Tax Administration and Research. Australia should pursue issues in these forums to seek certainty of jurisdictional rules, appropriate information sharing arrangements and international approaches to discouraging the development and use of low tax jurisdictions and tax havens;

3. The ATO should continue the ongoing work to measure the risks to income tax and the tax system generally from electronic commerce;

4. Tax return forms should be amended to require businesses trading on the internet to provide contact information such as uniform resource locators and e-mail addresses together with limited information indicating internet trading;

5. The ATO should negotiate with major international credit card and electronic payment system providers and seek international agreement to allow revenue authorities to obtain access to credit card transaction details held by credit card companies outside of the jurisdiction of the domestic revenue authority; and

6. The ATO should actively monitor the electronic commerce developments of the Banking and Finance Sector for new entrants, new payment system products, new financial products and changes in the residency status of industry participants.

4.1.4 Organisation for Economic Cooperation and Development ("OECD")

The report issued by the OECD in 1998 highlighted the following guiding principles to the taxation of electronic commerce transactions:

1. Existing principles of taxation should apply to E-commerce

   Various countries have agreed that existing principles should be used to tax e-commerce transactions. It is likely that in the future numerous changes might

be implemented after consultation with all major stakeholders. The key word for future policy, according to the OECD report is neutrality. The same transactions carried out using the internet and through conventional means should be taxed in the same manner.

2. No discriminatory taxes should be imposed on E-commerce

Every level of government imposes some form of discriminatory taxes to support or protect commerce in countries or states. In some countries, tax laws are regularly enacted to support individual companies and discriminatory taxes are also used to inhibit certain industries for example, tobacco and alcohol. Non-discrimination positions have already been adopted by the United States in the Internet Tax Freedom Act, which prohibits tax authorities from imposing discriminatory taxes on e-commerce.

3. Governments should adopt consistent principles of taxation

Governments should adopt consistent standards for cross-border taxation of e-commerce. The idea is to prevent double taxation and unintentional non-taxation.

4. Consumption taxes should be imposed at place of consumption

The taxation of cross-border transactions should be in the jurisdiction where consumption takes place. This is in line with the conventional model adopted by most countries including the United States, which imposes tax in the state where sales are made or where the products or services are consumed. This seems to differ from the Vat model where both goods and services are usually taxed at the vendor's location. Under the Vat model a relatively small number of services are taxed where they are consumed, but these are exceptions to the general rule. Without consistency across different jurisdictions on this principle, there is risk of double or unitentional non-taxation. The OECD is seeking to achieve international consensus on this issue.

5. Digitised products are not goods for consumption tax purposes

It is recognised that the place of supply rules can 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 software downloaded from the internet, should not be treated as goods for consumption tax purposes, but as services or intangibles. This is because digitized goods are composed of bits and bytes that cannot be seen or touched. This policy seems to contradict the one of neutrality and non-discrimination. If a product received by the buyer is identical to the product sent by the seller, then the mode of delivery should have no relevance to the character of the product.

6. Permanent Establishment

The OECD report provides for the application to e-commerce of the permanent establishment definition that exist in Article 5 of the OECD Model Tax Convention. The report provides that where a website hosted on a server is not owned by the enterprise maintaining the site it is not a permanent establishment because the website does not involve tangible assets and cannot be a physical presence. However, if the server is owned or rented to the enterprise carrying on its business through the website, it may be a fixed place of business and thus constitutes a permanent establishment.

The server would have to be in a specific place for a sufficient period of time to become a fixed place of business. Obtaining the services of an internet service provider will not constitute a permanent establishment since the internet service provider does not have the authority to conclude contracts for customers, but instead acts as independent agent. Finally, where e-commerce operations are carried on through computer equipment and limited to preparatory and auxiliary activities, no permanent establishment will exist.

The OECD report is one of many initiatives by various countries and organisations to address the challenges of e-commerce. There are clear indications of the direction in the report but as with the issue of digital products, there are indications of differences. The OECD has outlined the following basic tax principles to guide the international community in addressing the challenges posed by e-commerce:

Neutrality:	goods and services should be taxed the same regardless of the mechanism through which items are sold;
Efficiency:	compliance costs for businesses and governments should be kept as minimal as possible;
Certainty and simplicity:	businesses and taxpayers should be able to easily interpret tax compliance obligations;
Effective tax administration:	revenue authorities should maintain their ability to secure access to reliable and verifiable information in order to identify taxpayers and obtain the information necessary to administer their tax systems. Taxes should be levied at the appropriate point of sale and the potential for evasion and avoidance should be minimised;
Flexibility:	tax systems should be able to keep pace with technical and commercial developments;
Improving taxpayer service:	communication facilities and access to information can be enhanced to assist taxpayers and to improve response times. Electronic assessment and collection of tax should be encouraged and easier, quicker and more secure ways of paying taxes and obtaining tax refunds should be facilitated; and
Tax administration:	revenue authorities should maintain their ability to secure access to reliable and verifiable information in order to identify taxpayers and obtain the information necessary to administer their tax systems.

Consumption Taxes

The OECD's discussion paper on taxation issues identifies the following three broad categories of electronic commerce transactions that pose challenges to consumption taxes:

- Supplies of physical goods to both business and private consumers;
- Supplies from business to business of services and intangible property; and
- Supplies from business to private consumers of services and intangible property.

The first category is identifiable in the same manner as physical goods currently taxed at the border. The method of ordering is irrelevant in terms of taxation requirements particularly in European and North American countries, as electronic commerce is expected to lead to a significant rise in the volume of goods being purchased directly by consumers from foreign sources. The low value threshold for imported goods will mean that sales and consumption taxes will not be imposed on many of these supplies.

The second category of supplies can be identifies through the normal accounting requirements of a business. The taxation of these transactions can be enforced through the reverse charge system or self-assessment rules that apply to most consumption tax systems.

The third category, though small in volume with no immediate impact on revenue, may challenge the effective administration of consumption taxation. It is recognised that the international agreement and co-operation will be needed t develop solutions.

Within the general taxation framework principles outlined above, the OECD is seeking consensus at an international level to ensure the effective application of consumption tax systems to electronic commerce to achieve the following objectives:

- Prevents double and unintentional non-taxation;
- Protects tax revenue generally;
- Does not increase the opportunity for avoidance, evasion or fraud;

- Minimise the cost of compliance for business; and
- Does not hinder the development of electronic trade.

4.1.5 The European Commission ("Commission")

The commission's approach to the question of taxation of e-commerce has been motivated by the protection of tax revenue and ensuring that the development of e-commerce in the European Union ('EU') was not hindered by the distortive tax system. The key guiding principles raised by the commission are as follows:

1. no new or additional taxes need to be considered 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;

2. 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; and

3. services supplied for consumption within the EU should be taxed within the EU and those supplied for consumption outside the EU should be subject to EU Vat but deduction should be allowed on related inputs.

The commission believes that the consequence of taxation should be the same for goods and services regardless of the mode of commerce used or whether delivery is effected on-line or off-line. The consequence of taxation should be the same for services or goods whether they are purchased from within or from outside the EU. The commission is committed to removing administrative barriers to the growth of e-commerce caused by existing tax regulations. This has led to a study of all invoicing requirements to evaluate the possibilities of removing administrative barriers in this field.

4.1.6 International agreements

The United States, Japan, the World Trade Organisation, the European Union and the OECD, have all made policy statements regarding cross-border taxation of electronic

commerce. The statements are in general agreement that no new taxes should be imposed on electronic commerce. However, since countries and organisations are in the very early stages of creating international rules, disagreements are beginning to surface on some basic issues. The European Union has issued a statement on the character of digital transactions that seems to differ in fundamental ways with statements by other policy makers.

4.2 South African perspective

The government of South Africa issued a green paper on electronic commerce in November 2000. The paper intends providing a platform for translating issues around e-commerce into government policy.

The basis of the South African income tax system has changed from one of source to residence with effect from 1 January 2001. This represents a major policy change and seeks to provide answers to difficult questions posed by e-commerce and globalisation. Section 1 of the Income Tax Act, 58 of 1962, as amended, defines a domestic company as a South African company or a company, which is managed and controlled in the South Africa. In the field of e-commerce, a company may conduct business electronically with directors meeting by way of video-conferencing. In this situation, it will be difficult for the revenue authorities to establish whether the company is managed and controlled in South Africa.

The government acknowledges this problem and it has recommended that the concept of effective management as referred to in Article 4 (3) of the OECD Model Tax Convention be used to designate the tax residence of persons other than natural persons. Even after the proposed change, determining whether the company is effectively managed in the Republic could be problematic. This is an international problem and is the subject of efforts by the working group of the OECD.

Value Added Tax and other taxes ('Indirect Taxes')

The South African Commission on e-commerce suggests that the indirect taxes should be paid where consumption takes place and the international consensus should be sought on the identification of the place of consumption. The difficulties arise in that the supplier might not be able to determine the location of the customer and may be outside the jurisdiction where

consumption takes place. Consensus is essential to avoid double taxation or unintentional non-taxation as double tax agreements do not apply to indirect taxes.

Electronic Products

The supply of electronic products should not be treated as a supply of goods but a supply of services. This treatment will prevent the problems that could arise in relation to taxes on importation and application of 'place of supply rules'.

'Reverse charge' mechanism

The reverse charge mechanism requires the customer to account for output Vat on imported services, but also gives a right to an input tax deduction. This mechanism should be considered for the taxation of businesses that acquire services or intangible property from suppliers outside South Africa.

Private consumers

The collection of indirect taxes from private individual consumers is an area of concern with respect to the application of indirect taxes to e-commerce. The commission has suggested three options:

(i) the supplier is required to account for taxation in the country of consumption;

(ii) the customer is required to account for the tax. This is the current position where goods are not required to be entered through Customs and Excise or a service is rendered; and

(iii) the payment intermediary (e.g the bank or credit card company) is required to account for the tax.

The commission admits that all these alternatives are potentially unsatisfactory and that the best approach may be to require the supplier to account for the tax but to simplify the existing registration procedures.

South Africa believes that the blanket characterization of all on-line deliveries as supply of services by the OECD and the European Union, even where a similar product can be delivered physically at a zero or reduced rate, does not appear to be fair. Unless rates and other differences in treatment are equalized, this will result in heavier consumption of most electronic transactions. These problems are less likely to occur in South Africa because of the limited number of zero ratings and the uniformity of the system.

Customs and Excise

With the increased use of electronic media as a method of ordering of goods, there is likely to be an increase in the number of small packages arriving in South Africa. As e-commerce becomes more popular and a large number of small packages enter South Africa, so too will the workload of the customs increase. South African Revenue Services ('SARS') has already increased its presence at the three places of postal entry into the country.

Gaming and Betting

E-commerce will potentially facilitate the growth of internet-based gaming and betting. Virtual Casinos and betting places established outside the country will escape the need to be licensed as well as the duties payable unless this is addressed. The e-commerce forum of the Department of Communications would be the ideal facilitator in resolving this issue.

Stamp Duty

The impact of e-commerce in relation to stamp duty is where a transaction is carried out without the need for a hardcopy legal document. The United Kingdom introduced a Stamp Duty Reserve Tax in 1986 as a backup for stamp duty where a transaction was carried out without the execution of a legal document. South Africa is currently reviewing the impact of e-commerce to decide whether this kind of tax will be necessary.

Exchange control

On 23 February 1999, the South African Reserve Bank ('SARB') issued a statement stipulating that South African residents will only be allowed to make internet payments limited to R20,000. via credit or debit cards. It is hoped that the SARB would investigate the treatment of

small value transactions over the internet conducted by means of electronic money. Clarity should be provided on the application of regulations relating to software transmitted over the internet.

Tax administration and compliance

- Identification — accurate identification of the party responsible for paying tax is a fundamental requirement of any tax system. It is easy to identify conventional businesses as they operate from a physical and geographic location that can be visited. It is considered advisable for SARS and the consumer that minimum standard of information be required of enterprises using a website. The following information should be furnished on any commercial website owned by a South African resident business enterprise; trading name of the business, physical and postal address, e-mail address, telephone or other contact information and statutory registration number in respect of close corporations, companies and trusts.
- Information — although electronic records have been used for years, SARS has been able to place reliance on secondary sources within the country in order to verify the reliability of digital records. Developments in e-commerce will potentially alter this. A further problem is that the storage of information overseas is becoming easier and cheaper as a result of reduced storage and transmission costs. It is highly likely that many encryption keys will be stored overseas, particularly in respect of multinational enterprises.
- Evidence — in South Africa, tax laws have developed to provide a framework for the collection and retention of commercial documents by taxpayers and these documents can be used as a prime source of evidence in the court of law. South Africa will probably adopt the Australian Tax Office's approach that where integrity of electronic records can be verified and ensured the records should have the same standing as conventional paper documents.
- Collection — South Africa currently utilizes the leverage point collection mechanism whereby the employers collect pay as you earn on behalf of SARS from a significant number of employees. As e-commerce tends to eliminate the middleman, so too could tax collection efficiency be compromised.

Policy considerations

Residence basis of Taxation

A policy decision in this regard has been made as South Africa has adopted the residence-based taxation system with effect from 1 January 2001.

Electronic money

The South African Reserve Bank published a position paper on electronic money in April 1998. The document points out that emerging electronic money products may require regulatory adjustments or intervention in order to ensure that systemic and other risks to the National Payment System are limited, that consumers are adequately protected and that the Bank's monetary policy remains effective. Principles governing access to the records of electronic issuers need to be developed.

Identification of website owners

Principles governing the information to be furnished on any commercial website owned by a South African resident need to be developed.

5. Chapter Four: Research Findings

As e-commerce grows, internet sales-tax numbers will be too large to ignore and due to the internet's income generating ability, various governments are working hard on opposing any limits on their efforts to reap revenue to their jurisdictions. The potentially taxable e-commerce transactions include access to the internet, digitised services and tangible goods and services. Advocates of internet taxation claim that tax free e-commerce amounts to massive tax evasion. Isabel Isidro estimates that electronic commerce will result in the loss of US$4 billion per year by 2003. The loss of revenue will impair the ability of local governments to improve education, roads, public safety, health and other essential social services.

Some states in USA have argued that they might be forced to raise other taxes to make up for lost revenue if the call for internet taxation fails. Another argument put forward for internet taxation is that non-taxation will result in unfair discrimination over traditional retailers. There is no fundamental reason to provide favourable treatment to online transactions over similar types of transactions off-line. Calling for imposition of internet taxation would protect the revenue base as well as traditional business.

Proponents for non-taxing of e-commerce fear that the imposition of taxes would slow the growth and opportunity of e-commerce before it gets support among customers. They believe that extending the moratorium in USA will enable e-commerce to develop without market distortions caused by haphazard tax structures. Anti-tax policymakers and businesses opposed to these taxes argue that the internet should remain a global free zone, unencumbered by overlapping and discriminatory taxes imposed by taxing jurisdictions. A study by Austan Goolsbee revealed that one in four on-line shoppers would stop buying on the internet if the sales were taxed in a way similar to conventional retail, resulting in a 30% drop in on-line shopping.

Another important contention is the fact that the internet is inherently non-geographic. Chris Cox pointed out that the decentralised nature of the internet makes it impossible to establish the precise geographic route or endpoints taken by any transmissions. This makes every internet transmission vulnerable to multiple taxation that could seriously hinder growth of e-commerce. There is also a view that taxing the internet will drive internet companies to jurisdictions where they will not be taxed. It is believed that compliance with the thousands of differing local tax rates would burdensome on foreign companies, especially for small businesses or for sellers of digital goods that are delivered on-line as

they sometimes do not have the customer's mailing addresses. The fate of internet taxation is still unknown.

Electronic commerce is placing a severe strain and tension on existing domestic and international tax principles. The ability to transact business in another country without a physical presence may limit the ability of countries to impose source taxation on foreign businesses. E-commerce creates the potential for multinational businesses to restructure their business models and reduce the incidence of tax. The need for global consensus is important but the pressure for local tax authorities to protect their tax bases will be a difficult barrier to overcome.

6. Chapter Five: Conclusion

6.1 Summary of findings

The view by the UK that major changes are not necessary to existing tax legislation and regulation in incorrect in my view. The unique characteristics of e-commerce make it impossible to expand existing rules to include e-commerce as applying existing rules can lead to uncertainty for taxpayers, and possible tax evasions. The OECD, European Union and the UK Government and tax authorities broadly agree that;

international cooperation between revenue authorities is essential;

(i) no new taxes are needed. However, the dependence on a physical presence and a place of supply will need very careful examination;

(ii) tax rules and the methods of ensuring compliance should be consistent between traditional business transactions and e-commerce;

(iii) more effort should be devoted to consumption taxes (e.g. vat and sales tax) than indirect taxes (e.g. corporation tax) as problems arising from consumption taxes are more immediate; and

(iv) goods ordered and supplied electronically will be treated as services and be treated accordingly i.e. will not be subject to import duties.

One of the biggest problems facing businesses engaged in e-commerce is knowing which tax jurisdictions are involved. For on-line businesses, the uncertainty is important because technology poses new questions in jurisdictional standards. In most countries, the states have left the question of the limits of state taxing authorities to the courts and the courts are failing to solve the problem. Each decision is the subject of subsequent dispute and argument over its proper application. New theories are developed and more time and effort is spent litigating for certainty and predictability.

In the USA, the criteria to tax interstate transactions was established in Complete Auto Transit, Inc. v Brady, 430 US 274 (1977), under the judicially-created dormant commerce clause. This case provides that a state tax must meet four standards before a transaction can be taxed in that state.

(i) it must be applied to an activity with a substantial permanent establishment in that state;

(ii) it must be fairly apportioned;

(iii) it cannot discriminate against interstate commerce; and

(iv) it must be fairly related to the services provided by the state seeking to impose the tax.

6.2 Areas of future research

There is still a long way before tax authorities and businesses get to fully understand the tax implications of global electronic commerce. The UK authorities and the OECD have agreed that there should be neutral tax treatment between conventional and electronic commerce transactions. Whether this will work in practice is yet to be seen.

Is the PE concept still the appropriate threshold for determining the taxing jurisdiction?

One area that needs further research in an effort to resolving issues raised by e-commerce is whether the PE is still an appropriate threshold for determining the taxing jurisdiction. Even before the advent of the internet, and the rapid development of electronic commerce, it was recognised that there may be significant shortfalls with the operation of the traditional PE concept in the modern business environment. A leading authority on PE's, professor Skaar states:

'The mobility of business enterprise and the rapid development of modern communications in the world have changed the real life more fundamentally than is reflected by the changes in the PE concept'.

Skaar concluded that an enterprise of one country can nowadays more readily participate in the economic life of another country to a substantial extent without leaving a fixed place of business. This participation can be much the same as an enterprise that would be regarded as having a fixed place of business in the other country.

When the PE concept was first developed over one hundred years ago, an enterprise wishing to engage in any substantial trading or commercial activities in another jurisdiction would generally have needed to set up a physical base such as an office or shop from which the business of the enterprise could be conducted. However, the fact that an enterprise could conduct its business in another jurisdiction without establishing a physical presence of its own has been recognised for many years. The definition of a PE has long been extended beyond the original fixed place of business concept to encompass activities conducted on behalf of the enterprise by a dependent agent. Thus the present definition covers either a physical presence of the enterprise or a representative presence.

These days, many of the functions that previously required a physical or representative presence within a jurisdiction can be done remotely. The development of electronic commerce communication technologies has meant that physical presence by the enterprise or its agent within the jurisdiction where the foreign enterprise operates is often unnecessary for any significant length of time. Many of the functions traditionally carried out by a foreign enterprise through a local place of business or through an agent can be carried out through a website.

Even where similar business activities are conducted through websites, there may be different levels of physical presence. For example, one business may have its websites hosted by another entity on that entity's websites, whereas a similar business may find it necessary to have its own server in the jurisdiction.

Furthermore, not all forms of business can be conducted remotely. Some type of businesses still require a significant physical presence, such as manufacturing while some require a hands on delivery. Even businesses that can be adapted to electronic commerce may require a physical presence to differing extents for example internet businesses trading physical goods may require facilities within that jurisdiction. Consequently, the presence definition of PE that largely relies on physical manifestation of an economic presence, can give rise to anamalous and illogical results.

From the business perspective, the prospect of locating many of the functions of an internet business in an offshore website, either in the country or residence or in a low tax jurisdiction, is likely to be attractive. Thus, if a website or server is considered to constitute a PE in that jurisdiction, businesses may choose to relocate websited or servers to more favourable taxing jurisdictions.

Existing difficulties with allocating income between enterprise or between different parts of a multinational enterprise, where the income is derived from highly intergrated functions may also be execerbated in the e-commerce context. It is arguable that the PE concept, as is currently defined in the DTA's, no longer reflects the policy that underlies the business profits article. This article is clearly intended to provide a balance between the taxing rights of the jurisdictions where the enterprise is a resident, and the jurisdiction in which the income arises. The appropriate balance would neither unduly favour capital exporting countries nor capital importers, but would encourage trading relations between the two countries by reducing the incidence of double taxation and unnecessarily onerous tax compliance burdens on businesses.

At the time when the PE concept was developed, foreign enterprises that did not reach a sufficient level of physical or representative presence would generally have had a low level of participation in the economic life of the source country. However, business methods have changed dramatically in the past century, and the assumptions that underlie the existing PE concept as a measure of economic activity can no longer be relied upon to be correct. The level of physical presence within a jurisdiction does not always equate to the level of participation in the economic life of that jurisdiction.

In certain industries, a strict application of the current definition of PE means a foreign enterprise would be able to carry on substantial commercial operations within a jurisdiction without coming within the tax reach of that country. Those operations would go far beyond the level where a more traditional business would be subject to source country taxation. Some commentators have suggested that the existing rules of taxing business profits are capable of application in the e-commerce context, and any resulting shift from source country taxation to residence country taxation is a natural evolution of changing business methods. Such commentators argue there is no need for any changes to be made to the existing treatment of business profits or the PE concept.

Another view is that the existing physical rule was simply an appropriate means of drawing the line on the extent of participation in a country's economic life that should lead to taxing rights being allocated to that country. On this analysis, a change in the business methods should not lead to an abdication of taxing rights, but rather a change in the method of drawing the line.

6.3 Recommendations

The European Union ('EU') is unique amongst international organisations in that it is able to make rules and norms that are legally binding to all its member states or which confer rights and obligations on the citizens of the EU. Europe together with the USA, is one of the key test grounds for electronic commerce. As the USA and the EU are the largest trading blocks in the world, agreement between them would cover a large proportion of electronic commerce transactions. Any agreements between the two would pave the way to a global legal environment, as other states relying on trade with the USA and the EU would be keen to enact similar legislation or enter into agreements which would make electronic commerce easier.

Any kind of joint agreements must be quick, as all countries will implement their own measures and this will be problematic as it would be difficult to harmonise many individual laws than to encourage nations to follow a particular model. If worldwide agreement is to be found, one system needs to be adopted by the EU and USA in the hope that their trading partners will follow suit.

As e-commerce raises new tax compliance and administrative issues, 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 business. It is important for every country to give serious consideration to the impact on its trading partners of any new or amended rules of taxation of e-commerce. In order to minimise the potential for double taxation, an international consensus for taxation of e-commerce transactions should be reached. The OECD is the appropriate forum to hold the required international dialogue.

As e-commerce is not constrained by geographic boundaries, many purely domestic responses are likely to be partially effective at best, and totally ineffective at worst. There will be greater need than ever for international cooperation. Domestic identification arrangements will be totally ineffective where taxpayers engaged in electronic commerce shift their electronic commerce trading entities to a different jurisdiction.

To the extent that governments do not have undisputed practical jurisdiction there is likely to be loss of revenue. The effectiveness of international cooperation depends on broad-based international support. However, some countries like tax havens are likely to stand apart from such arrangements in order to attract internet business. Internationally agreed and co-ordinated responses are likely to be required to deal with expected non-co-operative parties such as tax havens. A consideration of the full implications of any particular form of international co-operation will be required before reaching a final position.

The taxation issues are being considered by the OECD but the newness and complexity of the issues to many OECD countries and the inherent nature of OECD meeting procedures have meant that progress has been slower than the world would have liked. A key concern is the USA approach that the communications revolution will see traditional source principles lose their significance and residence based taxation step in and take their place. This indicates that source and residency principles are equally at risk.

The overriding principle is that there should be broad neutrality between the treatment of businesses engaged in traditional commerce and those engaged in electronic commerce. This therefore means that, wherever possible and subject to the differences in the environments, businesses engaged in electronic commerce should be subject to the equivalent arrangements as businesses engaged in physical commerce. The main principles are:

(i) countries need to develop approaches to taxing rights for economic activity which occurs on the internet, for example, in respect of income derived from websites;

(ii) commercial anonymity is inconsistent with existing business practice and with proper administration of the tax law and internet businesses should be as visible as physical businesses;

(iii) well defined limits should be placed on transactional or user anonymity in electronic payment systems to ensure these do not become catalysts for tax evasion. This will provide the balance to the right to privacy with administration of the tax law;

(iv) records relating to the administration of a taxing law should be maintained in a form readily accessible to the taxing authorities; and

(v) enforcement powers in the internet environment relating to access, inspection of records, recovery of debts should correspond to physical world equivalents.

In seeking information from organisation involved in e-commerce to facilitate effective administration, the taxing authorities should minimise obligations on organisations which are involved in commercial aspects of the internet only in a small scale.

6.4 Conclusion

Electronic commerce raises many new problems and it is not only the pace of its adoption that causes difficulty, but that it is an entirely new form of doing business. The ease by which information may be transferred is partly responsible for the success of e-commerce but is also the cause for many of the problems. With the rapid developments in e-commerce, there has been a rush to enact new laws. These laws, however, suffer from two fundamental problems:

- the changing nature of e-commerce technology has the potential to render any legislation redundant within a short period of time; and

- national rules and regulations are inadequate to govern a global issue. As the communications revolution continues to sweep through the world economy, tax principles and systems of tax administration will have to adapt.

There is concern that regulation poses threats in that it risks stifling electronic commerce and hence business if it is unduly applied. The aim of any regulation should therefore be to facilitate the adoption of electronic commerce, or at least avoid distortion of the market through laws, which are not appropriate. Although countries like the UK believe that no major changes are necessary to existing tax legislation and regulation, it is also true that existing laws are not capable of being adapted to e-commerce.

However, because no one perfectly understands what e-commerce entails, how widespread it has become, and how it is likely to evolve in the future, it is difficult to reach consensus on

suitable regulation although to some extent it has been achieved through various international agreements that have been signed. One agreement takes precedent over the other and none are strictly binding. Of more legal effect are interstate agreements between the European Union, the USA and Japan. If a binding model agreement can be reached between these countries it will serve to encourage others to adopt similar legislation, hopefully leading to the certainty desired by business. Any taxpayer engaged in e-commerce should not only be concerned with the potential South African tax implications, but also with possible foreign tax implications.

The effective taxation of global collaborative activities will be critically dependent on internationally agreed traditional principles for the allocation of income and expenses across national borders. Such allocation normally involves looking at the relative value added by each component according to pre-agreed upon factors.

The USA has sought an international consensus in respect to global collaboration on the taxation of services, although the suggested basis for determining the place where the component services are performed appears narrow.

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