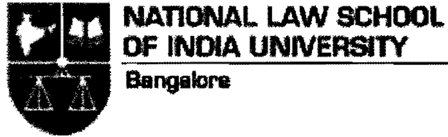


"TAXATION ISSUES IN ELECTRONIC COMMERCE"

DISSERTATION SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF LL.M. (BUSINESS LAWS)

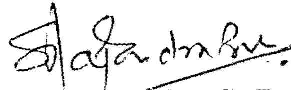
UNDER THE GUIDANCE OF
HON'BLE MR. JUSTICE S. RAJENDRA BABU

SUBMITTED BY:
ADITYA SHREYANSH
I.D No. 307

2010

CERTIFICATE

This is to certify that the dissertation entitled ***"TAXATION ISSUES IN ELECTRONIC COMMERCE"*** submitted by **ADITYA SHREYANH**, (ID No. 307) in partial fulfilment of the requirements for the award of degree **LL.M (Business Laws)**, is a product of the candidate's own work carried out by him under my guidance and supervision. The matter embodied in this dissertation is original and has not been submitted for the award of any other degree in any other University.



Honble Mr. Justice S. Rajendra Babu

(Former Chief Justice of India)

Date: 26.05.10

Supervisor

Place: NLSIU, Bangalore

DECLARATION

I, Aditya Shreyansh, do hereby declare that this dissertation titled "Taxation Issues in Electronic Commerce" is the result of the research undertaken by me in the course of my LL.M. (Business Laws) Programme at the National Law School of India University (NLSIU), Bangalore, under the guidance and supervision of Hon'ble Mr. Justice S. Rajendra Babu

This work is my original work, except for such help taken from such authorities as have been referred to at the respective places for which necessary acknowledgements have been made.

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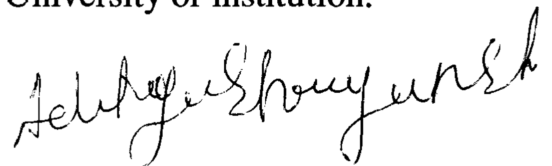

(Aditya Shreyansh)
I.D. No. – 307
LL.M. – Final
Year
NLSIU,
Bangalore

31st May 2010
NLSIU, Bangalore

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Chapter – 1

INTRODUCTION

It has become evident that the worldwide spread of the internet and other factors such as globalisation, have dramatically changed how business is conducted in local, national and multinational environments, creating opportunities and benefits for both businesses and consumers as well as posing new problems and challenges. Through the internet, businesses can now structure their activities cost-effectively and sell to a wider consumer audience without having to establish any local, physical presence near their desired markets.

A video game company, for instance, can now market and distribute its products for sale or rental directly to the public over the internet while having its server located in a low cost jurisdiction. Using web-based systems, core business functions (e.g. order and payment processing, inventory management) may be automated while other functions are outsourced to third parties. This reduces costs for consumers and gives access to new ways of buying products or services and comparing prices.

From a tax perspective, these changes have presented important challenges to the application of traditional tax rules and concepts such as "establishment" and "residence", originally developed for a business environment before the emergence of the internet. Many of these challenges therefore arise from the intangible and global nature of the internet and the greater ability of businesses to trade across borders, combined with the flexibility and potential anonymity the internet affords cross-border transactions. These challenges are compounded by the potential for different implementing legislation in individual countries, creating compliance and

revenue risks for the tax regimes of the jurisdictions in which the business is, and greater uncertainties for businesses.

In order for tax to operate within the prevailing business environment, both governments and businesses have recognised that there needs to be a balance between ensuring that tax revenues are fairly secured whilst also providing a clear fiscal environment that does not restrict e-commerce, or e-business,[1] development.

In finding this balance, work programmes on e-commerce tax issues have been actively pursued at the highest international level, particularly by the European Commission (Commission) and the Organisation for Economic Co-operation and Development (OECD - the primary forum for cooperation in matters of international taxation). In recent years, those work programmes have led to the development of a number of legal initiatives, mainly directed towards providing practical solutions for the implementation of the 1998 Ottawa Taxation Framework Conditions; a broad set of tax principles which were formulated to guide governments in their tax treatment of e-commerce. Particular attention has been given to modernizing, rather than replacing, existing tax mechanisms, and to creating some degree of international coherence in their application to e-commerce.

EMERGING TAX POLICY - AN OVERVIEW

History

[1] These terms tend to be used interchangeably but it is understood that e-business is the newer, wider term to refer generally to the use of computer networks to facilitate transactions (both internally and externally) and not just e-commerce, i.e. the selling and buying of products and services to customers over the internet. This chapter mainly refers to the term "e-commerce" since this term has been used more substantially within OECD documents.

Tax issues related to e-commerce have been, and continue to be, the subject of international discussion and collaboration through the OECD, the EU and the World Customs Organisation, involving input from all levels of the international community - governments, various taxing authorities, tax professionals and the business community itself.

In a Communication in April 1997,[2] the Commission stressed the need to ensure that tax obligations in relation to e-commerce were clear, transparent, predictable and, so that there was no extra burden on e-commerce as opposed to more traditional forms of commerce, neutral. Furthermore, the importance of implementing tax rules which did not create market distortions was also emphasised. In the Joint EU-US Statement on Electronic Commerce of December 5, 1997, it was also accepted that the taxation of e-commerce should be "clear, consistent, neutral and non-discriminatory".

The subsequent Commission Communication of June 1998[3] expanded upon the principles laid down in the 1997 Communication and set out the following key guidelines for the way forward:

(i) efforts should be concentrated on adapting existing taxes, and in particular VAT, to the developments of e-commerce: no new or additional taxes should be considered;

(ii) a supply of digitised products via an electronic network should be treated for VAT purposes as a supply of services;

(iii) services, whether supplied by e-commerce or otherwise, which are

[2] Communication from the Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions: A European Initiative in Electronic Commerce, COM (1997) 157.

[3] Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: Electronic Commerce and Indirect Taxation, COM (1998) 374 final.

supplied for consumption within the EU should be subject to VAT within the EU (whatever their origin) and services supplied for consumption outside the EU should not be subject to EU VAT, although VAT on related costs or "inputs" should be eligible for deduction; and

(iv) the VAT regime should ensure that taxation is enforceable on supplies of services received within the EU via e-commerce by both businesses and private individuals.

This Communication had been prepared in anticipation of the OECD Ministerial Conference on Electronic Commerce which took place in Ottawa in October 1998. Pursuant to that conference the Ottawa Taxation Framework Conditions were published by the OECD Committee on Fiscal Affairs addressing four areas: tax treaties, consumption taxes, tax administration, and taxpayer service.

The key conclusions mirrored those reached independently by the EU and US. It was stated that the taxation principles that guide governments in relation to conventional commerce should also guide them in relation to e-commerce. These principles were the principles of neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility.

Thus, the consequences of taxation should be the same for transactions in goods and services regardless of the mode of commerce used, whether they are purchased from within or from outside the EU and whether delivery is effected on-line or off-line, so that no particular form of commerce is advantaged or disadvantaged.

Compliance costs for taxpayers and administrative costs for tax authorities should be minimised as far as possible. The rules should be clear and simple to understand so

that the taxpayer can anticipate in advance the tax consequences of a transaction. Furthermore, the rules should not result in double or unintentional non-taxation but in the right amount of tax being paid at the right time and in the right country.

They should minimise the potential for evasion and avoidance and be flexible and dynamic enough to Weep pace with technological and commercial developments.

The Committee believed, at that stage of development of internet commerce, that existing taxation measures could implement these principles. However, new or modified measures were not precluded provided that they Assisted in the application of existing principles and were not intended to Impose a discriminatory tax treatment of e-commerce or resulted in an funfair distortion of competition which would result from a de facto double taxation or non-taxation of e-commerce vis-a-vis fully taxed traditional commerce.

So, it can be seen that the consensus was that there were to be no new or special e-commerce taxes. Rather, the existing tax structure would be made [to work using the above-mentioned guiding principles.

The Framework Conditions established an ambitious timetable to study and decide upon the various implementation options identified in the paper. Key elements of the work programme included how payments for digitised products should be characterised under tax treaties; in what circumstances a website may constitute a permanent establishment giving rise to tax jurisdiction in the country where the server on which it is hosted is located; and, in relation to consumption taxes such as

VAT, obtaining a consensus on defining the place of supply and on internationally compatible definitions of services and intangible property.

RECENT DEVELOPMENTS

Since agreeing the Framework Conditions, both the EU and the OECD, 13-003 through its Committee on Fiscal Affairs and the business/government technical advisory groups established by it to examine e-commerce tax issues, have made considerable progress towards their implementation.

The OECD's review has covered all the main tax areas to be addressed; namely international direct taxes and tax treaties, consumption taxes; and tax administration/taxpayer service, with continued input from businesses and non-OECD governments. Its work programme has involved a detailed analysis of the tax implications of e-commerce activities and has led to a number of important conclusions and recommendations. These are now available on-line in various guidance documents, discussion drams, progress reports and technical papers.[4] A brief overview of the implementation work is given below, some of which will be detailed later in this chapter.

Direct taxes

International discussions on the application of the "permanent establishment" concept to website servers and how e-commerce payments may be characterised for

[4] Please refer to the OECD's website at: *www.oecd.org/taxation* for publications and documents in relation to electronic commerce.

tax treaty purposes have resulted in clarifications to the OECD's Commentary on its Model Tax Convention on Income and Capital.[5]

Two other key issues have been the subject of discussion drafts[6] which are well-advanced but these have not yet resulted in changes being incorporated in the OECD's Model Tax Convention. The first of these concerns a refinement of the concept of "place of effective management" in determining which jurisdiction has primary taxing rights given that it is now possible for a company's board of directors to hold meetings (e.g. via video conferencing) simultaneously in different locations. The second is a critical examination of the adequacy of current treaty rules for the taxation of business profits, including transfer pricing,[7] in the context of e-commerce by reference to the Framework Conditions.

[5] The Convention comprises a set of principles on the taxation of income and capital, and is used by countries, including the UK, when negotiating bilateral agreements to eliminate double taxation. See further at section 13.27.

[6] Namely; "Attribution of Profit to a Permanent Establishment involved in Electronic Commerce Transactions" and "The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as the Tie Breaker Rule", both released in February 2001; "Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention" released in May 2003; and "Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce", final report released in December 2005

[7] See further below at section 13.30.

Consumption taxes

Notably, significant attention has been given by the OECD towards achieving an international consensus in the field of VAT. The EU has complemented the OECD's work by focussing its efforts on dealing with shortcomings in EU VAT legislation. Their work programmes have progressed along the same lines: reaffirming the principle of taxation at the place of consumption, and simplifying traders' obligations via effective tax collection mechanisms that do not impose undue burdens on business.

To assist member governments, the OECD has, for instance, published a Consumption Tax Guidance Series (the "Guidance") to develop greater awareness of policy and administrative issues for e-commerce taxation.

This Guidance endorsed draft guidelines set out in a draft report from the ECD's Working Party No.9 on Consumption Taxes to the OECD's Committee on Fiscal Affairs in February 2001,[8] and the UK, together with the Commission and other Member States, contributed to the development of this work. The Guidance addresses tax issues such as defining the place of consumption for cross-border supplies of services and intangible property in the context of e-commerce, verifying customer status and location, simplifying VAT registration procedures, and contains recommended approaches to the practical application of the Guidance.

Although not legally binding, OECD member countries are encouraged to review existing national legislation to determine its compatibility with the Guidance and to align such legislation with the objectives of the Guidance (i.e. to remove conflicts,

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[8] This repot is available for review on the OECD's website at : http://www.oecd.org/ dataoecd / 37 / 2673667 .PDF.

distortions and disincentives to international trade). In the UK for instance, customer verification guidelines on the latest EU developments for VAT generally mirror the OECD's Guidance on verification.

Meanwhile the Commission's work has led to temporary amendments being made to the EU place of supply rules for charging VAT on the supply over electronic networks of software and other digitised products generally in order to re-establish a balance of competition between EU and non-EU suppliers.

Broadly, these measures provide that supplies of "digitised products" will be taxed in the country where the customer resides, i.e. at the place of consumption, which will ensure that such supplies from non-EU operators to private customers inside the EU are chargeable to EU VAT.

Novel tax administrative measures have also been adopted, allowing the option of simplified registration, filing, and payment mechanisms for assisting compliance by non-EU operators. As it was a particular priority of the Commission to deliver solutions capable of implementation in conformity with the Framework Conditions, the new rules are largely consistent with the OECD's Guidance and the EU is reported to be the first tax jurisdiction to tax internet services in line with the Framework Conditions.

Tax administration and taxpayer service

In the area of tax administration and taxpayer service,[9] OECD governments have reached a broad consensus on the main administrative challenges and opportunities

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[9] The OECD has established a Forum on Tax Administration and various papers can be found at the following link:*http:/fwww.oecd.org/department/0,2688,en_2649_33749_1_1_1_1_1,00.html.*TheTaxAdministration Guidance Series is available at: *http:// www.oecd.org/dataoecd/25l3QIl 7851138.pdf.*

facing tax administrations, and on the type of responses they need to consider in improving the application of technology to tax administration and taxpayer service. The general assumption is that technological developments will is essential to maintain and simplify current tax systems to ease burdens, costs and encourage compliance. So a range of options have been reviewed: such as the development of technology to allow non-EU suppliers to remit tax for multiple jurisdictions, the electronic availability of consumption tax rates, comparable/common technical and audit standards across jurisdictions, standardised registration and filing requirements, simplified tax returns and automated tax payments, electronic record-keeping and storage.

A key area for discussion has been jurisdictional verification, i.e. how to satisfactorily identify an internet business, and the mechanisms available for tracing inadequately identified websites and other electronic places of business. A detailed "Tax Administration Guidance Series" has also been created as a result of this work, encouraging appropriate standards for internet business identification (including website contact information), appropriate standards for record-keeping, appropriate transaction data for audit purposes, and accountability in electronic payment systems.

Tax administrations are also being encouraged to share practice and experience and develop systems which will provide a supportive environment (e.g. call centres) for e commerce traders which have to cope with the sum of requirements for compliance across countries. Finally, on-line government functions for reporting, declaring and collecting tax are now more readily available.

RESEARCH METHODOLOGY

SCOPE

This dissertation is an attempt to bring forth the nuances of taxation aspects of electronic commerce and critically analyzing the international taxation regime in the light of the same.

An analysis of various laws and policies put forth by various tax jurisdictions has also been done in an attempt to find out the probable solutions for the challenges faced by the electronic commerce and the need to reach a consensus to determine the way forward and ensuring steps for future implementation works.

OBJECTIVE

The main objective of this paper is to examine various taxation issues arising out of electronic commerce.

- Determining electronic commerce
- Examining the need for taxing electronic commerce
- To look into various laws, policies and taxation structure of various tax jurisdictions
- To look into the probable solutions to the challenges and their feasibility
- To look into the international tax regime for electronic commerce and way forward

RESEARCH STATEMENT

The taxation issues involved in electronic commerce need to be resolved for the purpose of taxing all electronic transactions uniformly and establishing a uniform international taxation regime

RESEARCH QUESTIONS

- What is electronic commerce?
- What is the need to tax electronic commerce?
- What is the tax structure in various tax jurisdictions?
- What are the tax challenges faced y electronic commerce?
- What is the solution to the challenges?
- What is the international tax regime for electronic commerce?
- What is the way ahead?

CHAPTERISATION

This dissertation is divided into eight chapters. The first chapter introduces the topic and the concept. The second chapter deals with as to what is electronic commerce. The third chapter brings out the necessities for taxing the internet base commerce. The fourth chapter deals with the tax structure of various taxing jurisdiction. The fifth chapter deals with various taxation issues faced by electronic commerce. The sixth chapter deals with the various solutions that have been put forward and their feasibility with regard to the taxation issues in electronic commerce. The seventh chapter deals with the international taxation regime. The eight and the last chapter puts forward the future implementation work relating to taxation issues in electronic commerce and the conclusion.

SOURCES

The researcher has used secondary sources of reference for the purpose of this dissertation and the methodology used in this project is generally analytical and descriptive. The tool of comparison has been adopted wherever necessary and an attempt has been made to understand the resolve the problem involved therein.

CITATION

A uniform mode of citation has been adopted throughout this dissertation.

Chapter – 2

WHAT IS ONLINE TRANSITION AND E-COMMERCE?

Internet[10] has no formal definition in law but most of the industry commentators would accept the description of the internet as a network of networks, merging all sources of information into a single retrievable database. Oftel[11] defines the Internet in its glossary to a number of information and publicity documents issued to industry as '......a global network of networks, mainly narrowband, accessed by users with a computer and a modem via a service provider.

Electronic Data Interchange (EID) is the earliest manifestation of what is now known as e-commerce, Dating from the mid-1960s, the beginnings of EDI are seen in the clearing system for banks and in airline passenger reservation systems. Various definitions of EDI have been used over time, with the UNCITRAL Model Law on electronic Commerce providing the most widely accepted one. It considers it to be the electronic transfer from computer to computer of information using an agreed standard to structure the information.[12]

BACKGROUND TO INTERNET COMMERCE :

With the rapid growth of the Internet, the processes by which e-commerce is conducted have amplified. E-commerce includes retailing and wholesale businesses, online newspapers and other information sources, services (pay-per-use schemes for online databases, subscription services, online healthcare services, are a few

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[10] International network
[11] Office of telecommunication- the designated authority in UK
[12] UNICITRAL model Law on Electronic Commerce

examples), online gambling services,[13] videoconferencing,[14] offshore and inland banking, stock trading, etc., everything that traditional commerce can offer.

An understanding as to the mechanisms involved in the operation of the Internet is necessary.

All machines connected to a Network are generally identified by their IP numbers the Internet is no exception. Devices communicate with each other through this IP-number system, acting much like two conventional telephones. To make matters easier, specific IP numbers denoting a computer is given a domain name. The communication (data) takes place in the form of "packets"[15] which can traverse through several networks before reaching their destination. The format and transmission of data is through the use of several protocols. The most common protocol used on the Internet is TCP/IP.[16] Data Packets are of specific size and if the data they contain exceeds this size, it is split up and transmitted. Furthermore, the data portion of a packet can be encrypted for better security. Generally, packets are made to take the shortest route to their destinations, taking into account Internet traffic and other reasons. Using this analogy if Packet 1 and 2 representing a part of data intended to be sent from Host *A* to Host B, there is no guarantee that 1 and 2 would traverse the same network. This is particularly problematic when Tax Jurisdictions are to be determined, since data packets traverse through different networks traversing diverse geographical locations to arrive at their respective destinations. This is not a limitation of technology, but one of tax principles. Thus, any goods that can be converted into a digital form can be transferred from Point *A*

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[13] Includes online casinos whose servers are either located in Tax Heavens or where gambling is legal

[14] Video conferencing is a collaborate tool for persons to communicate

[15] A typical "packet" contains header and a data part

[16] Shot for transmission control protocol

to Point B via the Internet in the form of data. A second vital constituent of the Internet is a "host."[17] Permanent Hosts on the Internet are connected permanently to the Internet and are allotted specific IP addresses. Hosts can be a conglomeration of servers demarcated internally, but sporting a single IP address for domain name purposes. These hosts connected to the Internet can be used for commercial purposes as well. Thus, a website is a software programme that resides on a server connected to the Internet. Websites can be used as sales cum distribution unit for products traded via the Internet.

Let us now look at the "players" involved in various commercial transactions on the Internet:[18]

Player 1: The Network Provider- the Network Provider forms part of the Internet backbone providing requisite amount of bandwidth.

Player 2: The Internet Service Provider (ISP)—Contracts with individual users, companies and organisations to provide access to the Internet in the form of dial-up or leased accounts for a requisite fee. The ISP also provides space on his servers for hosting Websites et al.

Player 3: The User: The most important player in the commerce model. All systems of commerce including purchase, sale, payment and others are structured around the user.

Player 4: The Website: The Website contracts with the ISP to host its business. The User contracts with the Website for purchase/sale of goods, products or services. If Products or Goods are intangible and exclusively for online use, the website may

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[17] A "host" acts as a computer that provides clients with access to files and printers
[18] Courtesy "taxation of the internet" Australian Government publishing services, Canbera, 1997

contract with a content-provider to provide the requisite products and goods. Else, if the website represents a manufacturing concern or is its own content provider, it may offer its products for sale. Otherwise, Websites may have to offer royalty for content providers for the purchase of rights or license fees for products.

Player 5: The Payment Providers: In real-life, payment providers like Visa, MasterCard offer efficient collection methods through the use of credit cards, various form of electronic money (e-cash) and the like. Mostly, tangible forms of money such as paper currency support online payment mechanisms.

Player 6: The Payment System Provider: They provide underlying technology and guidance for payment providers to function. Payment Providers need to seek a license from Payment System Providers. (Ex: Cybercash, RBI, etc.)

Player 7: The Software Architects: They provide applications for both clients and servers to enable efficient commerce over the Internet.

Player 8: The Advertiser: Much like the advertisers in Television and radio, online advertising is big business. Typically taking the form of banner advertising and email adverts, the advertiser contracts with websites to supply ads, primarily to increase the number of users visiting the website.

Player 9: The Content Provider: The Content Providers provide products and goods to websites for sale. They, in turn, receive a part of the sale proceeds or royalty or both from the websites.

Player 10: The Back End Systems: These are software applications that maintain inventory and accounting. Typically database products from Oracle and Microsoft are examples.

Other Players: Search Engines like Yahoo, Altavista that list various Internet sites and are incidental to the success of e-commerce will be included in the category of "Other Players".

Thus, Internet Commerce introduces a whole new range of personalities into commerce. How is a tax system to be structured around these new entrants? Keeping all of these players in mind, a tax revenue model must be evolved considering the interaction between each of them for the provision of services and generation of revenues.

E-Commerce includes a range of Internet activities which can be categorized as follows:[19]

- Advertising medium: the Internet provides a vehicle for advertising products and services.
- Communications device: a means of delivering many types of information which is directly or indirectly incorporated into other products.
- Sales of services: examples such as financial advice, insurance or pension's information which can be provided remotely by exchange of 'e-mails' and used to improve investment performance or to reduce tax liabilities.
- Sales of digitized products: examples such as computer based Learning materials (software), music recordings or electronic text information (electronic books). These can be sold over the Internet without ever appearing in physical format.

[19] William J.Craig, Taxation of E Commerce, Lexis Nexis, pg 8

- Sales of physical products: examples such as any catalogue product which can be ordered over the Internet (electronic mail order) and then delivered by post or courier.

E-Payments

Payment for electronic transactions can be made by submission of debit card details online, requiring the co-operation of payment providers to ensure security for the transacting parties[20], through conventional electronic funds transfer (DFT), or through the use of the notional trading systems known as electronic money or any real knowledge of the respective whereabouts of the transacting parties. Indeed, electronic money is one of the fastest growing offshoots of e-commerce.

Is e-commerce different?

E-commerce is one of the greatest gifts of modern technology. This is the first generation which is using such a technical method of commerce. The peculiarity of e-commerce transaction is its function which involves Internet as a platform to perform it. And this makes e-commerce different from conventional commercial activities. E-commerce has no physical geographical boundaries, and thus within cyberspace any distance is eliminated, it is global. Physical presence is minimal in comparison to the "virtual" presence, something which is also applicable to the human intervention necessary for e-commerce, as well as the minimum documentation or complete lack of actual documentation regarding an online transaction. Also, in e-commerce there is evident the reduction of intermediaries, as well as the deficiency of actual physical control over it. Another significant difference is the fact that while conducting business online, the transactions are

[20] Moscovitch, Taxation of Internet Commerce 1997

mostly anonymous; no face-to-face basis between seller and consumer. Thus, it is an established fact that the e-commerce is considerably different to conventional one. Now question arises, if it is considerably different from the conventional system than is there any need to tax on it? If yes, then who is able or suitable to regulate it? And what should be the mechanism of taxation over it? It has been the argument of internet libertarians that internet should be free from any regulation by governments.[21]

Modes of E-commerce

Let us now look into various modes through which e-commerce operates. A broad visualisation of E-Commerce suggests four modes of operation:

Advertising/Sale/Lease/ License of Tangible products over the Internet- includes goods and products such as shrink-wrapped software, CD's, books, machinery etc.

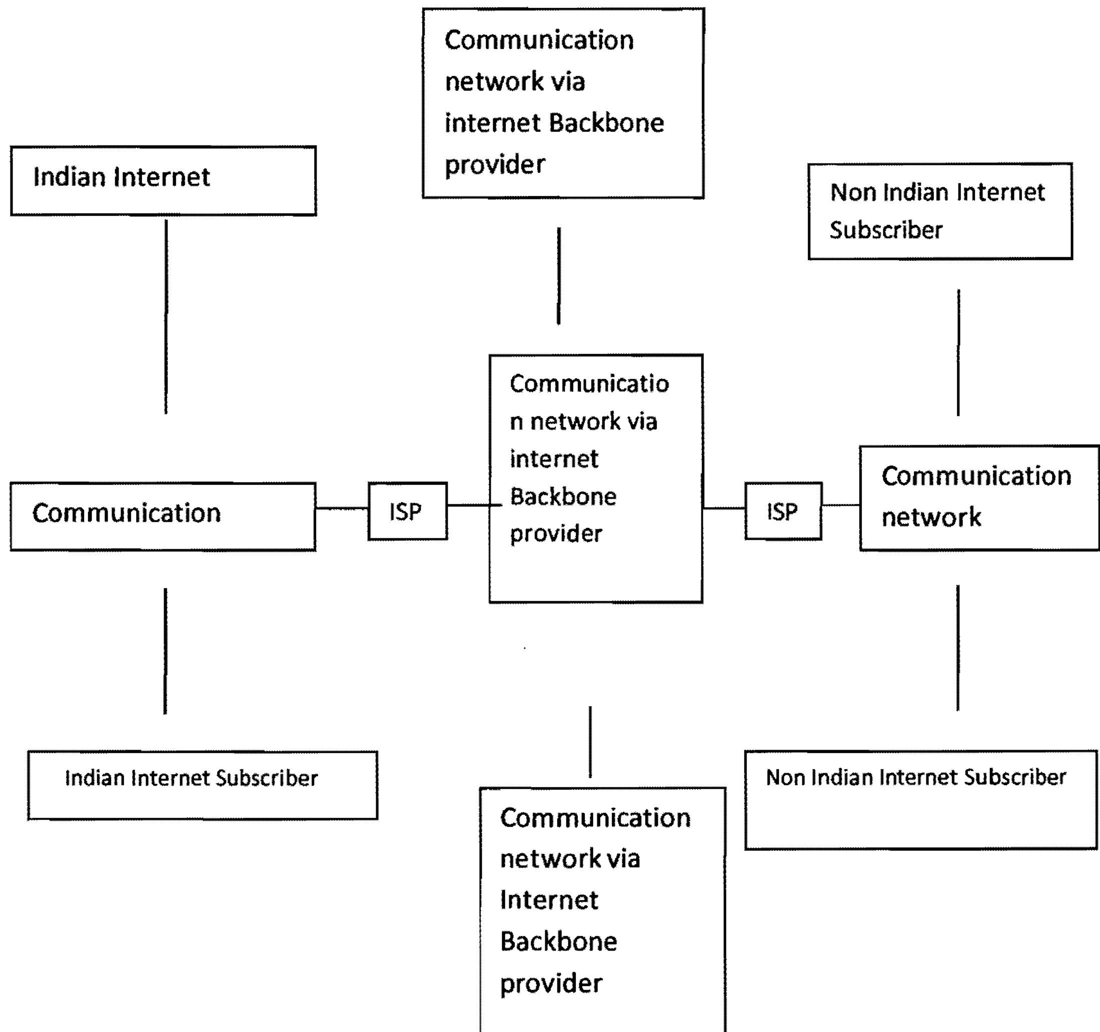
Advertising/Sale/Lease/License of Intangible content such as software downloads, digitised forms of music available for downloads, electronic newspapers, photos, and services offered by online databases. In many cases, an intangible product such as subscription for an online newspaper allows the same to be taken as a printout a hard copy. It may be argued that this constitutes a tangible medium- it is not- the cost of printing is not included in the cost of an online newspaper, whereas it is so in its traditional paper-based counterpart. Advertising/Sale/License of services such as offshore software development, online newspapers, online ticket bookings, trading in stocks and shares, online banking, online casino games etc. May include push-content as well, if such a service is subscribed to. Commerce in the form of advertising/providing/selling/leasing/ licensing Internet access and

[21] Lessing Lawrence- Cyberspace, a contemporary Utopia ?- Journal of Law and Technology 1998 (3)

telecommunications. Here we are concerned with ISP's and backbone service providers. *Advertising/sale/lease/license of tangible products* over the Internet is the electronic counterpart of our traditional mail order systems. Electronic counterparts of mail-order systems function as advertising, marketing and selling medium for tangible products derived from content-providers. Not only does advertising take place through online advertisers, but can also utilise other media such as television or radio to enhance the exposure a commercial website offers.[25] Sales through a website result in shipping of tangible goods or products to customers around the world. *Advertising/sale/lease/license of intangible content* lies at the heart of E-Commerce. With the advent of cable-modems, the speed and bandwidth are no longer any issues for arguments of bottlenecks in transmission of digitised content over the Internet. Intangible content does not stop at software, digitised music et al; the whole gamut of entertainment and pay per view channels are taking a new turn with digitized signals transmitted to satellite receivers, part of which can also be transmitted over the Internet. Net trends also point toward convergence of computers and televisions to provide entertainment with the broadcasting medium being the Internet. This would result in products being customized for individual needs and thus undergo a process of value addition. Finally, Intranets are projected to overtake the growth of the Internet within the next five years. It has been estimated that approximately 35-40% of Fortune 1000 Companies use Intranets already, whereas in 1994, the number of Intranets was almost nil.

Thus, the Advertising/Sale/Lease/License of Intangible Content extends to all the above frontiers as well; and that too in real-time. In addition, the very nature of the Internet makes geographic demarcations meaningless. Companies or individuals providing these services can be located anywhere on Earth, and are not limited by

local laws and conventions. "Taxes not only helped to create the state. They helped to form it... If the tax state were to fail and another form of providing for the wants of the community ensued... what we call the modern state would itself change its nature."



The above diagram shows how e-commerce works

Chapter - 3

NEED FOR TAXATION OF ELECTRONIC COMMERCE – A BURNING DEBATE

The development of E-Commerce has revolutionized the way business operates. It has also challenged the adequacy and fundamental validity of principles of international taxation such as physical presence, place of establishment etc. that has formed the basis of asserting tax liability.

The uniqueness of the internet stems from the opportunities it has created on the commerce aside. Goods and Services are available from a variety of sources having their presence on the internet and it offers luxury and convenience to the average consumer. A state is now confronted with a leviathan in the form of the Internet and cyberspace. This has triggered new means of monetary instruments that respond to the real value of money in cyberspace, and not to artificial means controlled by government apparatus. As wealth is generated through the means of cyberspace, accounting mechanisms and monetary control would become difficult. Then what would be the status of a political sovereign leverage toward? Taxes on cyberspace would be one method of getting some amount of monetary control- this is because taxes involve less of coercive force "imprisonment," and are usually collected at a point-of-sale.[22] On the other hand, creation of wealth through cyberspace would also entail the use of "offshore" financial institutions to store this wealth. In other words, this would constitute an elaborate and often untraceable from of tax avoidance. This is not only a treatment to national sovereignty but also overrides traditional

[22] Point of sale is used to explain the working of the mechanism and is not to be construed on its actual denomination because it generally denotes the sale of tangible goods and subsequent indirect taxes

principles of taxation - a transgression of traditional nations of political and monetary autonomy.

(A) Arguments In Favour Of Internet Taxation

a) The main argument in favour of taxing e-commerce is that failure to do otherwise would inevitably lead to an eroding government tax base, as businesses and consumers alike turn away from the traditional modes of trade in favour of a tax-free haven in cyberspace.[23] The taxation of goods and services provides governments with a vital source of revenue for the provision of public services and regulatory activities. This means that the imposition of taxes in cyberspace is necessary to preserve the provision of the public benefit in the real world.

b) A secondary argument in favour taxing e-commerce is based on fairness and neutrality. A fundamental principle of taxation law is said to be that of neutrality. Tax neutrality holds that a fair and equitable tax system must treat economically similar income equally.[24] In the context of emerging technologies such as the Internet, this means income earned through electronic commerce should be taxed similarly to that earned by more conventional modes of commerce. There is no reason, why what is effectively a 'tax subsidy' should be imposed on the Internet industry - especially when such an industry grows at the expense of conventional 'brick and mortar' retailers.[25] In essence, commerce should take place on a level playing field, be it conducted electronically or conventionally.

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[23] Blair Downey, E Commerce Taxation Nemesis (2002): John E Sumunu, Policy Essay- The Taxation of E Commerce(2002) 39, Harvard Journal of Legislation 235
[24] Clayton W. Chan, Taxation of Global E Commerce on the Internet, underline issues and proposed plan (2000) 9, Minnesorta Journal of Global Trade 233
[25] James J. Jourinski, Federalism and state taxation of E Commerce, is the end insight for state sales taxes (1999) 18, Journal of State Taxation

c) The final pro-taxation argument is perhaps more novel than the previous two. It has been argued that given the present chaotic state of taxation laws both domestically and internationally, the imposition of taxation in cyberspace, and thus across both national and international borders, would provide a much need 'jolt' for tax legislators, forcing a simplification of the .tax system for all forms of commerce, not just the Internet.

(b) Arguments against Internet taxation

1) The first argument advanced against the imposition of Internet taxation is that it burdens the development and growth of the Internet and electronic commerce. The development of small Internet-based companies with little capital may be stifled, as they are unable to cope with tax burdens." Indeed, it has been argued that the perils of taxing the Internet extend well beyond the small trader. It has been suggested that the Internet is so beneficial a technology that its growth and development should not be discouraged by the imposition of taxation.

The problem with such arguments, however, is that they are not unique to the Internet. The perils of taxation and the burden of tax liabilities are experienced by *all* traders—not just those who engage in e-commerce. It would seem to violate the principles of fairness and tax neutrality if people can avoid paying government dues simply by virtue of adopting a technological means of commerce.

2) A further argument advanced in opposition to Internet taxation is that the Internet is essentially a private realm that should be considered beyond the purview of government intervention in the form of taxation. However, such arguments encounter criticism, particularly from the US government, when it is remembered that the Internet first developed as a government run Defence project in the 1960s and 1970s. Furthermore, this argument only really relates to the taxation of Internet use itself, rather than the taxation of income generated by conducting business via the Internet.

   Indeed, to suggest that because what takes place over the Internet is in reality a private business matter and therefore beyond the reach of government taxation is again to suggest an Internet-specific argument that is not in fact unique to the Internet. The issue goes back to fairness, equality, and tax neutrality. It can be said of many private commercial transactions that they do not involve public or governmental dimensions; nevertheless, they, too are taxed on a par with other transactions.

3) Finally, it has been suggested that the most compelling argument against Internet taxation is that government tax laws are incapable of keeping pace with rapidly developing and emerging technologies. The thrust of this argument seems to be that the Internet is such a complex and dynamic means of doing business tisat it is best to avoid the trouble of trying to tax it. The flaw in this argument is immediately apparent. Further, the idea that laws should be avoided because they are too difficult to maintain suggests a response favouring development of flexible and technology-neutral legislation.

Chapter - 4

TAXATION FRAME WORK

There are good reasons to believe that, the rise of global electronic commerce will stimulate a substantial broadening and strengthening of the international tax regime. But this does not mean the state will cease to collect taxes themselves, or that a supranational taxing authority will be created, but rather, that the rise of e-commerce is likely to precipitate a shift in the relative balance of *de facto* taxing authority from the domestic to the international level as states come to realize that technological changes in the nature of commerce require higher levels of international tax policy coordination. This conclusion rests on several premises: (1) that international e-commerce will continue to grow; (2) that the spread of this commerce will challenge existing systems of taxation; (3) that national governments will ultimately demand the taxation of digital commerce; and (4) that the effective taxation of electronic commerce will require extensive international coordination.

Some international organizations such as OECD, UNCITRAL etc., have been working very sincerely for international consensus on e-commerce issues in the areas of taxation and other economic affairs. OECD gives an infrastructure to the various tax jurisdictions to harmonize their tax laws and to solve their economic issues on the basis of consensus. The organisation in fact in 1998 submitted a report to implement the Ottawa Taxation Framework. Full implementation has not yet been

achieved. However the guideline protocols, which were endorsed by over 40 countries, are as follows: [26]

- Neutrality- taxation should seek to be neutral and equitable between forms of e-commerce and between conventional and electronic commerce, so avoiding double taxation or unintentional non-taxation.
- Efficiency- compliance cost to business and administration costs for Governments should be minimized as for as possible.
- Certainty and simplicity- tax rules should be clear and simple to understand. So that taxpayers know where they stand.
- Effectiveness and fairness- taxation should produce the right amount of tax at the right time, and the potential for evasion and avoidance should be minimized.
- Flexibility- taxation systems should be flexible and dynamic so that they keep pace with technological and commercial developments.

A. Indian Legal Framework

In India though a very large section of citizen has no access of internet but the internet business is taking place very rapidly and heavily. So naturally it will attract the taxation liability under the legal framework of the country. Some of the issues and legal mechanism regarding that shall be dealt with in this chapter.

Domain Name- capital asset-Indian scenario

In *Rediff Communication ltd. V. Cyberbooth* [27]a very interesting issue was discussed. In this court opined that an activity engaged in the electronic commerce on the

[26] William J. Craig- Taxation of Electronic Commerce, Lexis Nexis, pg 81

internet may be identifiable by its domain name and a domain name has many of the attributes of a trademark. Thus internet domain names are of importance and can be a valuable corporate asset.

This judgment of Bombay High Court is of vital importance because it is impossible to levy taxes without accurate identification of taxpayers. And even if the taxpayer is identified, his physical location may give rise the jurisdictional issue. Here domain name may be a good base to solve the jurisdictional issue. One more very important tax aspect regarding the domain name is that if it is sold to any other person than what would be the tax implications? Registering domain name and sell it to other is a very common phenomenon now a day. So question may arise that whether the consideration received for the transfer of a domain name is gains arising out of sale of a capital asset or business asset so as to be treated as income from capital gains or business income? In *Voltas Ltd. V. Deputy* 677[28] the Tribunal held that consideration received on sale of a brand name or trademark is a capital receipt and hence not liable for taxation due to nil cost of acquisition.[29] The tribunal also held that registration fee paid for a trademark cannot be considered as the cost of acquiring the Trademark.

CAPITAL OR REVENUE EXPENDITURE AND DEPRECIATION

When an asset which has a life extending for a period of over a year is purchased, the expenditure is characterized as capital, else revenue expenditure.

The difficulty arises in characterizing the payment made for registration of a domain name and for either acquiring a server or taking it on rent/license, and any other

[27] AIR (2000) Bom 27
[28] [1998] 64 ITR 232 (Bom),
[29] CIT v. B.C. Sri Nivas Setty (1981) 198 ITR 294

incidental initial expenditure including on development of software. If it is treated as capital expenditure on the conclusion that the domain name has an indeterminate life, it may fall under the purview of the definition of "block of assets" under section 2(11) of the Act like a trademark and depreciation may be allowed.[30]

Chargeability of Income Tax on e-commerce

Under the Income-tax Act, 1961 and individual is taxed on the basis of his residential status whereas companies/firms are taxed on the basis of incorporation/registration, control and management subject to the provisions of DTAAs. The following specific sections may be more relevant apart from other sections for determining the taxability of transactions undertaken through the internet.

Section 1 of the Income-Tax Act extends the scope of the Act to whole of India. But section 1(2) of the IT Act, 2000 extends the scope of the act and makes it extraterritorially applicable. But as to how it shall be exercised is still under the question. Section 5[31] and Section 6[32] says about the total income and residence in India respectively. Explanation to section 5(2) clarifies that income which has already been taxed on the basis of accrual or deemed accrual shall not be again taxed on the basis of receipt or deemed receipt. It also provides that merely because an item is taken into account in the balance-sheet prepared in India, it should not be deemed to be received in India when the income has accrued or arouse outside India.

Under section 6(3) of the Act, a company is treated as a resident in India in a previous year, if it is an Indian company or during the relevant year, the whole of the

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[30] Rediff Communicatio Case
[31] Income Tax Act, 1961
[32] Ibid

control and management of the affairs of the company is situated in India. Residence of individuals is generally determined by looking to objective manifestations of whether an individual has established his or her allegiance to the country by joining its economic or social life. The 182 days test must be enforced by strict recording of border crossings in order to identify that person as a resident of a country. Now in the context of the internet the 182 days test becomes even more untenable. The geographic location of a person has historically been important in affecting where that person is resident. A person could effectively make thousands of trips per year via the information highway to another jurisdiction without ever being subject to a border control mechanism. Sourced based rule deemed income -

Section 9 deems certain income to accrue or arise in India, even if it may not strictly accrue or arise in India. Under section 9(1),

- Income from business connection in India
- Income from property in India
- Income from any asset or source of income in India, and,
- Income from transfer of capital asset situated in India.

Business connection

The term "business connection" is not defined in the Act. Therefore, it would be prudent to construe its meaning as given in Circular No. 23 of 1969, dated July 23, 1969, and the decisions of the Supreme Court in CIT v. Toshoku Ltd[33] and in CIT v. Agarwal and Co.[34] holding that there has to be some continuity of relationship between the person resident in India and a person outside India, which yields profits

[33] (1980) 125 ITR 525
[34] (1965) 561 ITR 20

or gains contributed by the activity undertaken in India, i.e., the relationship should have some territorial nexus between the income earned and business activity in India.

Section 9 does not seek to bring into the tax net the profits of a non-resident, which cannot reasonably be attributed to operations carried out in India. Even if there be a business connection in India, the whole of the profit accruing or arising from the business connection is not deemed to accrue or arise in India. It is only the portion of the profits, which can reasonably be attributed to the operations of the business carried out in India, which is liable to income-tax. These provisions of section 9 are subject to DTAA entered into by India with other countries. In a very remarkable judgment by Madras High Court in 2000[35] it was held that Indian income-tax cannot be assessed on consideration amount, where documentation was delivered in Switzerland and payment thereof was also made in Switzerland.

Similar view was expressed by Calcutta High Court[36] which was affirmed by Supreme Court in the case of ITO v. Sri Ram Bearings Ltd.[37]

So far as e-commerce is concerned it needs to be examined whether a server can constitute a business connection in India. As per the laws of India, a business connection I would exist in India where some activities are carried on in India and they contribute to the non-resident's profits outside India. Accordingly, if the server is located in India, it could be viewed as a business connection in India. Further, if the server is located in India, the income generated from the activities carried on

[35] CIT v. Machinery Works (2000) 243 ITR 442
[36] IPO v. Sri Ram Bearings (1987) 169 ITR 419
[37] (1997) 224 ITR 724

through the server may be classified as income from property, asset or source of income in India and hence may be deemed to accrue or arise in India.

Royalties and fees

Under section 9(1)(VII), royalties and fees for technical services respectively are deemed to accrue or arise in India when they are payable by:

- Government, or
- A person who is resident except when the right, property, information or services is used or utilized for the purpose of a business or profession carried on by such person outside India or for the purposes of marking or earning any income from any source outside India, or
- A non-resident when it is payable in respect for the purpose of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

The term royalty is given a restricted meaning in the DTAA as compared to the term defined in *Explanation 2* of section 9(1) (vi) of the Act. If the payment though falling within the meaning of the term royalty as defined under the Income-Tax Act does not fall within the meaning of the said term in the DTAA, it cannot be taxed under the Income Tax Act. In case the payment falls within the term "business profits", it is chargeable to tax in India, if the foreign constituent has a permanent establishment in India. Another question regarding royalty tax is very important to discuss here is "whether Payments of digitalized information such as software, books, music, programmes etc, would come within the purview of royalties or business profits?" Here it is important to say that the tax treatment of digitalized information would depend upon the substance of the transaction and cannot be

generalized. However, digitalized information involving goods may be taxed as business profits if a permanent establishment or business connection is shown to exist, but the digitalized information involving the right to use may be taxed as royalty income. Further, the digitalized information involving technical, consultation or professional services may be taxed as fees for technical, consultation or professional services may be taxed as fees for technical services. Thus taxability of digitalized information would depend on the facts of each case and the classification of payments maybe decided accordingly.

Tax deduction to source from payments made to non-residents- Section 195

Transactions in e-commerce via the internet would make the provisions of section 195 almost impracticable as payments would be made directly through credit cards and the payer may not know the status of the non-resident through whom the dealing is executed. It may so happen that even the identification of the owner of the website is unknown or a situation similar to that before the Bombay high Court in the case of *Rediff Communication Ltd* may arise. In consequence to this, if the tax is not deducted from the payment made to the non-resident outside India, no deduction of the payment may be granted in terms of the provisions of section 40(a) (i) of the Income Tax Act. In *Transmission Corporation of A.P. Ltd. V. CIT.*[38] the apex court has held that section 195 is for tentative deduction of tax at source subject to regular assessment and by the deduction of income tax; the rights of the parties are not in any manner adversely affected. What is required to be done is to file an application for determination by the Assessing Officer that sums would not be chargeable to tax

[38] (1999) 239 ITR 587 (SC)

in the case of the recipient. In such determination, tax at the appropriate rate could be deducted at source.

Double Taxation Avoidance Agreements

The central Government has entered into Double Taxation Avoidance Agreements with more than 100 countries (comprehensive agreements with 83 countries and limited agreement with 20 countries) Serbia[39] and Saudi Arabia have also signed DTAA with India at later point of time.

Most of the Indian Treaties are based on the OECD model. The scope to Section 90 has been elaborated in Circular No. 108, dated March 20, 1973. Section 90(2) provides that there the Central Government has entered into an agreement with the other country for 'granting relief of tax or avoidance of double taxation, the provisions of this Act shall apply to the extent they are more beneficial to the assessee. Thus in case of conflict between the provisions of DTAA and other Tax laws, DTAA shall prevail.

Indirect Taxes

Levying of Indirect Taxes on the business carried on through internet is a very big problem for the Taxing Authorities. The problem arises when products having high information value that can be transformed digitally and transferred electronically. India, among the other countries taxes only the value of the carrier media and not on the value of the information content, thus bringing down the overall customs rate.

[39] Income Tax Notification No 5/2009, dated 7/01/2009

The puzzle is of taxing the value of the product also, which is a daunting administrative task for customs authorities. The one easy solution is to let it be, and continue with the policy of taxing the carrier medium only. That would involve applying a "bit rate" tax for every bit of information downloaded from websites selling intangible products. This can be done by taxing Internet businesses based on their domains, especially the ".com" domain hierarchy, or through IP addresses. The WTO agreement on Customs Valuation has given the members the option to tax the value of the carrier media only, or to include the information value in the customs valuation. India is yet to take a decision in this regard.[40]

E-commerce and VAT: issues

As a multi-stage tax, the modern VAT collects revenue at all stages of production and distribution.[41] In close connection with the multi-stage nature of this tax, VAT provides for the right to recoup the tax paid by the business participants of the supply-chain. The right to regain the VAT is put into practice by the application of the credit-invoice administrative method. Taxable person and Non-traceability of income and the taxpayer are the two major hurdle of VAT implications on Online transactions. Within the current VAT regime, the taxable person is a central player. The VAT system is built up around the concept of the taxable person.

Effective enforcement of tax laws, as with other laws, requires accurate identification of a party and evidence that can be linked to the party, In fiscal matters this equates to identifying a taxpayer, obtaining evidence of income and linking the income to the taxpayer.

[40] Chetan Nagendra, an Introduction to the Indian tax structure and the challenges posted by internet commerce
[41] Schenk, Alan and Old Man, Oliver (2000) value added tax 26 trans national publishers, 2000 pg 29

There are two major ways tax authorities seek to verify disclosed income tax liabilities. One is "specifics" method[36] and the other is "non-specific" methods[37]. The specifics method examines transactions which have been disclosed or partly disclosed to the revenue authorities and seeds to establish by an examination of the relevant facts and law whether or not a particular item is taxable or is a legitimate tax deduction. This method is unlikely to change under the new environment but the techniques used to apply this method must be adapted to take into account technological developments. The "non-specific" method is not a single method as such. It is a collection of non-specific methods which are related to measurement of assets or spending and funds over time, frequently supplemented by inspection of particular matters such as trading stock. The growth of unaccounted electronic payment systems and electronic commerce are creating problems in application of this method. This non-specific method has some obvious weaknesses.

B. EU Model for uniform taxation

The European Union has issued a directive known as the electronic commerce directive which provides that a member State shall apply its national laws to a service provider established within its territory. Wherever be the location of technology, marketing or domain address, what is important as per the directive is the principal place of business. It also requires disclosure of full identity of the service provider. This is the most important aspect and essential data if any law relating to taxation of e-commerce is to be successful. The UN also has drafted a model law relating to taxation of called 'United Nations Commission on International Trade Law' (UNCITRAL) in December 1996[11]. This differs greatly

from the EU directive as it treats e-commerce as equivalent to written paper communication.

Recent Developments

Since agreeing the Framework Conditions, both the EU and the OECD, 13-OOj through its Committee on Fiscal Affairs and the business/government technical advisory groups established by it to examine e-commerce tax issues, have made considerable progress towards their implementation.

The OECD's review has covered all the main tax areas to be addressed; namely international direct taxes and tax treaties, consumption taxes; and tax administration/taxpayer service, with continued input from businesses and non-OECD governments. Its work programme has involved a detailed analysis of the tax implications of e-commerce activities and has led to a number of important conclusions and recommendations. These are now available on-line in various guidance documents, discussion drafts, progress reports and technical papers.[4] A brief overview of the implementation work is given below, some of which will be detailed later in this chapter.

Direct taxes

International discussions on the application of the "permanent establishment" concept to website servers and how e-commerce payments may be characterised for tax treaty purposes have resulted in clarifications to the OECD's Commentary on its Model Tax Convention on Income and Capital.

Two other key issues have been the subject of discussion drafts which are well-advanced but these have not yet resulted in changes being incorporated in the OECD's Model Tax Convention. The first of these concerns a refinement of the concept of "place of effective management" in determining which jurisdiction has primary taxing rights given that it is now possible for a company's board of directors to hold meetings (e.g. via video conferencing) simultaneously in different locations. The second is a critical examination of the adequacy of current treaty rules for the taxation of business profits, including transfer pricing, in the context of e-commerce by reference to the Framework Conditions.

Consumption taxes

Notably, significant attention has been given by the OECD towards achieving an international consensus in the field of VAT. The EU has complemented the OECD's work by focussing its efforts on dealing with shortcomings in EU VAT legislation. Their work programmes have progressed along the same lines: reaffirming the principle of taxation at the place of consumption, and simplifying traders' obligations via effective tax collection mechanisms that do not impose undue burdens on business.

To assist member governments, the OECD has, for instance, published a Consumption Tax Guidance Series (the "Guidance") to develop greater awareness of policy and administrative issues for e-commerce taxation. This Guidance endorsed draft guidelines set out in a draft report from the OECD's Working Party No.9 on Consumption Taxes to the OECD's Committee on Fiscal Affairs in February 2001, and the UK, together with the Commission and other Member States, contributed to

the development of this work. The Guidance addresses tax issues such as defining the place of consumption for cross-border supplies of services and intangible property in the context of e-commerce, verifying customer status and location, simplifying VAT registration procedures, and contains recommended approaches to the practical application of the Guidance.

Although not legally binding, OECD member countries are encouraged to review existing national legislation to determine its compatibility with the Guidance and to align such legislation with the objectives of the Guidance (i.e. to remove conflicts, distortions and disincentives to international trade). In the UK for instance, customer verification guidelines on the latest EU developments for VAT generally mirror the OECD's Guidance on verification.

Meanwhile the Commission's work has led to temporary amendments being made to the EU place of supply rules for charging VAT on the supply over electronic networks of software and other digitised products generally in order to re-establish a balance of competition between EU and non-EU suppliers.

Broadly, these measures provide that supplies of "digitised products" will be taxed in the country where the customer resides, i.e. at the place of consumption, which will ensure that such supplies from non-EU operators to private customers inside the EU are chargeable to EU VAT.[42]

Novel tax administrative measures have also been adopted, allowing the option of simplified registration, filing, and payment mechanisms for assisting compliance by non-EU operators. As it was a particular priority of the Commission to deliver solutions capable of implementation in conformity with the Framework Conditions,

[42] Graham J.H. Smith, internet Law and Regulation, Sweet and Maxwell publishers pg 1035

the new rules are largely consistent with the OECD's Guidance and the EU is reported to be the first tax jurisdiction to tax internet services in line with the Framework Conditions.

Tax administration and taxpayer service

In the area of tax administration and taxpayer service,[9] OECD governments 13-006 have reached a broad consensus on the main administrative challenges and opportunities facing tax administrations, and on the type of responses they need to consider in improving the application of technology to tax administration and taxpayer service.

The general assumption is that technological developments will emerge and create new methods of administering taxes. However, in the interim, it is essential to maintain and simplify current tax systems to ease burdens, costs and encourage compliance. So a range of options have been reviewed: such as the development of technology to allow non-EU suppliers to remit tax for multiple jurisdictions, the electronic availability of consumption tax rates, comparable/common technical and audit standards across jurisdictions, standardised registration and filing requirements, simplified tax returns and automated tax payments, electronic record-keeping and storage.

A key area for discussion has been jurisdictional verification, i.e. how to satisfactorily identify an internet business, and the mechanisms available for tracing inadequately identified websites and other electronic places of business. A detailed "Tax Administration Guidance Series" has also been created as a result of this work, encouraging appropriate standards for internet business identification (including

website contact information), appropriate standards for record-keeping, appropriate transaction data for audit purposes, and accountability in electronic payment systems.

Tax administrations are also being encouraged to share practice and experience and develop systems which will provide a supportive environment (e.g. call centres) for e-commerce traders which have to cope with the sum of requirements for compliance across countries. Finally, on-line government functions for reporting, declaring and collecting tax are now more readily available.

Further implementation work

In its latest progress report on the implementation of the Framework Conditions, the OECD's Committee on Fiscal Affairs confirms that the most frequently quoted principle during its analysis has been that of the neutrality of taxation between electronic commerce and conventional commerce. Flowever, it has also noted that this principle may be breached if the taxation of e-commerce continues to be studied in isolation to international tax issues impacting conventional commerce.

The OECD's Consumption Tax Technical Advisory Group ("TAG") released a report in 2003 on e-commerce implementation issues which considered two further issues high on the political agenda: the potential for double taxation or non-taxation as a result of conflicting place of supply rules, conflicting definitions, conflicting tax results arising from differences in verification requirements between jurisdictions, and incompatible approaches to "bundling" issues, i.e. where an e-commerce supply involves a number of different elements.

That report identified different approaches which have been taken by countries to the taxation of cross-border services and intangibles in national tax systems. The emerging international view is that such differences have increased the potential for double taxation and unintentional non-taxation, not just for e-commerce, but in the broader context of international trade in services and intangibles where consistency between countries is increasingly essential. Consequently, focussing on e-commerce issues as a separate category of services alone may mean that issues affecting other internationally traded services will be missed or lead to further international conflicts.

The OECD, through its Committee on Fiscal Affairs, is therefore adopting a more "holistic" approach to taxation, rather than on specific aspects such as e-commerce. This is not to say that the Framework Conditions are 110 longer relevant—although they were designed in the context of e-commerce, the international view is that they will remain valid as they broadly reflect the philosophies and policy goals of existing tax rules in most countries. However, the Framework Conditions and related work on e-commerce, are now being incorporated into the Committee's mainstream work on international commerce issues.

This is illustrated by the Committee's latest project on the application of consumption taxes to international trade in services and intangibles, for which further tax principles and remedies are being developed, and is also consistent with the approach being taken by the Commission to amend the EU VAT place of supply rules on a wider basis and not just affecting internet traders (see further under the heading "The Future" at section 13.24).

Therefore, it would now seem that any further policy work specifically on e-commerce is only likely to arise as a result of the EU and the OECD's monitoring of e-commerce developments and new technologies, where these may significantly challenge the international consensus reflected in the work achieved to date, and which may necessarily require refinements to treaty rules or new taxes to be introduced.

C. United Kingdom Legal Framework

Liability to tax in the UK is, in the main, imposed by a statutory framework consisting of the annual Finance Acts which follow the budget each year, dedicated statues which govern specific taxes within the tax regime; management statutes; and consolidation statutes which periodically bring interim developments together in a cohesive format.[12] VAT, which is an indirect transactional tax, is administered by HM Customs and Excise. Direct taxes on profits and gains are administered by the Inland Revenue (HM Inspector of Taxes), using the powers granted under TMA *1970.* The UK tax system applies to income and chargeable gains which are derived from the worldwide activities of UK resident persons, whether individual or corporate, and to related transactional charges which derive from economic activity. Additionally, non-resident can expect to be subjected to UK tax upon activities which are carried out within the UK. In case of e-commerce more than one jurisdiction is involved, taxation depends upon the bilateral agreement or OECD guideline etc.

In October 1998, the former UK Inland Revenue and FIM Customs and Excise published a joint paper on UK tax policy[43] regarding e-commerce. Not surprisingly,

[43] Electronic Commerce: UK Policy for the taxation Issues for the OECD Conference in Otawa, Canada, November 8,9

the paper was almost identical in content to that of the Framework Conditions. At about the same time legislation[44] was passed in the United States which imposed a three year moratorium (until October 2001) on new taxes on internet access fees and prohibited "multiple and discriminatory" taxes on e-commerce at either the state or the federal level. It did not, however, prevent a tax authority from imposing a previously existing tax on e-commerce transactions provided that the tax was equally applicable to e-commerce companies and traditional companies. This legislation also created a Congressionally-appointed Commission, whose remit was to determine how e-commerce should be taxed, if at all.

In April 2005 the Inland Revenue and Her Majesty's Customs and Excise merged departments to become "Her Majesty's Revenue & Customs", (hereafter referred to in this chapter as the "UK Revenue"). Following that merger, the UK's 1998 joint paper regarding e-commerce has been withdrawn, but as an active contributor to the development of international tax policy, the UK has continued to support and implement into its own tax regime the approaches taken by the OECD and the EU on the taxation of e-commerce.

So, on a purely domestic level, UK tax policy seeks to promote the Framework Conditions, particularly the principle of neutrality to ensure that UK residents conducting business via the internet in the UK are taxed in the same way as persons running a traditional, physical business.

Meanwhile in the United States, the Congressionally-appointed Commission concluded its study in 2000 making a series of findings and recommendations but

[44] Internet Tax Freedom Act of 1998

without reaching a consensus on the central issues. In November 2001 new legislation was passed to extend the moratorium introduced by the 1998 Internet Tax Freedom Act for a further two years, and in November 2003 the US House of Representatives passed the Internet Tax Non-Discrimination Bill, a piece of legislation designed to permanently extend the moratorium. That Bill was not approved however by the US Senate and a compromise Bill was subsequently passed in December 2004 which has extended the moratorium by four years (retroactively to November 1, 2003) and is due to expire on November 1, 2007(We have yet to see wheather the Government will, permanently extend the moratorium in 2007.

GROWTH OF E-COMMERCE AND VAT

The application of VAT to the supply of goods and services via the internet is considered first because, as highlighted above, this area has been given significant attention internationally, and its correct application presents the biggest practical problems for businesses operating over the internet, as well as for tax authorities themselves.

The importance to governments of the correct VAT treatment of e-commerce must be appreciated, as consumption taxes are becoming an increasingly important means of raising tax revenues worldwide. It has recently been reported that consumption taxes account for more than 30 per cent of overall taxation in OECD member countries. Perhaps more tellingly, a VAT (or Goods and Services Tax/GST) is now in place in every OECD Member State except the US (although a sales and use tax operates at the sub-federal level).

In the EU, VAT rates currently vary between 15 per cent and 25 per cent and it typically accounts for one-fifth of a country's total tax receipts,[15] and, as an own resource, for around 15 per cent of the Community's budget. It has also been acknowledged that the substantially increased importance of VAT has served to counteract the diminishing share of other specific consumption taxes, such as excise and custom duties (for example on tobacco, alcoholic drinks and fuels).

In the UK, a report investigating the UK Revenue's administration and collection of VAT on e-commerce was published in May 2006 by the National Audit Office ("NAO").[45] According to the NAO's report, around 22 million Britons shopped on-line in 2005 buying a wide range of items such as CDs, electrical goods, food and holidays, and in the period 2005 to 2006, the UK Revenue collected over *£l* billion in VAT on e-commerce goods and services. It is also reported that internet sales in the UK alone are expected to rise to £60 billion a year by April 2010 so that the proportion of UK VAT to be collected from internet sales is likely to grow substantially.

D. United State Legal Framework

Coping with the enormous problems, US government has passed legislation called the Internet Tax Freedom Bill. According to this, a three year moratorium from October 1, 1998 on Internet has been imposed. The Bill allows electronic commerce to flourish by blocking taxes at the state and local levels.

The 1996 US Model Tax Convention contains its own Article 7, which has language similar to that of the OECD Model Tax Convention.[13] Therefore, with regard to

[45] "HM Revenue and Customs VAT on E Commerce" Report

most of its treaty partners, the United States limits profits to those attributable to a PE. However, a much different tax regime exists for companies subject to tax in the United States that are not resident of treaty countries. For those companies the US tax law is subject to tax in the United States, all of its US-source profits are taxed in the United States, not just those profits attributed to a US-based business activity.

Taxation of royalties

Under both the OECD and US Model Tax Conventions, royalties are taxed only in the country of the beneficial owner of the royalties, unless the royalties are earned through a PE in the other country. However, a number of countries the treaties may lower source taxation of royalties they do not eliminate it. This is the case, for instance, in the treaties between the United States and Canada, Australia and Japan.[14] With regard to non-treaty countries, taxation of royalties at source appears to be the norm. So far as the determination of profit to physical establishment is concerned, there is a two-step approach in US. According to this approach first of all, a functional and factual analysis are done to identify the operations taking place in PE and the relationship of the operations to an enterprise as a whole. Arms-length transfer-pricing principles are the used to determine the amount of profit to be allocated to the physical establishment, taking into account the functions performed, the assets used and exploited, and the risks assumed.

The second step involves traditional transfer-pricing methodology. The TAG prefers the comparable uncontrolled price method, and recommends a comparison of transactions between the PE and the enterprise of which it is a part, with transactions between unrelated parties. Such an analysis is done, however, only when identifiable transactions take place.

Chapter - 5

TAX CHALLENGERS FACED BY ELECTRONIC COMMERCE

The nature of Internet and more specifically its commercial part has shown rapid growth in the last few years. E-commerce has an international nature, it is inherently non- territorial. The lack of geographic boundaries has helped increased the amount of e-commerce activity; small sized companies can become international players by using e-commerce.

Due to absence of national boundaries, and physical presence of goods and non-requirement of national boundaries, and physical presence of goods and non-requirement of physical delivery, taxation of e-commerce transactions gives rise to several issues. These have to be understood in the light of international taxation. International taxation arises from cross border transactions, the person who makes transactions is in one country and the sites of the transaction are in another country which is known as (Host State). Income arising out of such transactions will be subject to tax in both countries by virtue of permanent attachment' to the income itself in the host state. Thus, this gives rise to double taxation of the same income. This problem is generally solved by a 'Double Taxation Avoidance Agreement' between the two countries concerned.

All of this presents significant challenges to tax administrations around the world: tax administration is the key to an effective tax system which raises the revenue that governments need - particularly in developing countries - to finance the social and physical infrastructure required for self sustaining development. Today many

developing countries lack an effective tax Administration and this is certainly a major constraint on their development.

In order to determine economic attachment, the sites of the transactions should be clearly determined. In a traditional commerce transaction, the sites of the transaction are clearly known, because of the physical presence and the physical delivery. Therefore, the Source Rule as laid down in section 9 of the Income-Tax Act, 1961 can be clearly applied to effect Host State taxation. Section 9, provides that income is deemed to accrue or arise in Indian taxable territory if there is a business connection. In e-commerce situations, with transactions being completed in cyberspace, it is often not clear as to the place where the transaction is effected, giving rise thereby to difficulties in implementing Source Rule taxation.

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A. TAXABLE JURISDICTION

It is a general principle in the physical world that the laws of a particular jurisdiction normally only have effect within the boundaries of that jurisdiction. The application of this principle to physical world activities is comparatively straightforward; the geographical location of an actor or an object at the relevant time is objectively determinable[46], and on that basis the application of local law and the appropriate jurisdiction can be decided.

[46] In theory at least. In practice, the distributed structure of the Internet may make discovery of the physical location of any electronic 'object' almost impossible

The geography of the Internet, however, is purely virtual. In operation it pays no heed to geographical or political boundaries. Furthermore, the physical world location of those parts of the Internet infrastructure via which a communication is carried may be purely fortuitous. The result in many cases is that the parties to an Internet transaction are faced with overlapping and often contradictory claims that national law applies to some part of their activities. In the physical world such overlaps are comparatively rare and, except in private law actions, are often ignored as being too trivial to require legal action[47]. In the Internet world these overlaps are pervasive, and have the potential to stifle legitimate activity or even to encourage deliberate law-breaking.

This issue of overlap raises three detailed questions which are discussed in this chapter:

- Where an Internet activity has a cross-border element, on what principles can we decide which country's law applies and which court has jurisdiction?
- On what basis can a national Government claim to apply its laws and regulations to Internet activities which originate in a different jurisdiction?
- How far, if at all, is it possible to resolve the conflict between differing national laws where the only effective means of compliance is to limit information flows across national boundaries?

Where do Internet transactions take place?

The principles for establishing applicable law and jurisdiction in cross-border transactions were established many years ago, well before the invention of computers and

[47] Eg financial services advertisements are strictly controlled under most national laws, but action is almost never taken against an advertiser in a magazine which is not intentionally distributed in that country.

digital communications networks. Private international law, or conflict of laws, determines these matters by deciding whether a relevant clement of the transaction can be localised in the jurisdiction in question. We therefore need to ask where an Internet transaction occurs or, more pertinently, where each element of that transaction takes place.

As has already been pointed out in the Introduction, it is easy to be seduced by the cyberspace fallacy. This concept, particularly attractive to technologists and idealists, states that the Internet is a new and separate jurisdiction in which the rules and regulations of the physical world do not apply a seamless global-economic zone, borderless .and unregulatable.[48] Internet activities, so the argument goes, do not take place anywhere in the physical world, but occur solely in this new place called 'cyberspace'.

If this conception of cyberspace as a separate jurisdiction were well founded, the problems outlined above would not exist. Competing claims of national law would be denied on the ground that the transaction occurred exclusively within the jurisdiction of cyberspace, and is thus governed by its laws, customs and practices[49].

The problem with cyberspace is that its constituent elements, the human and corporate actors and the computing and communications equipment through which the

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[48] John Perry Barlow' Thinking Globally, Acting Locally' (1966) Time, 15 January. Barlow has written elsewhere that 'digital technology is also erasing the legal jurisdictions of the physical world, and replacing them with the unbounded and perhaps permanently lawless seas of Cyberspace. In Cyberspace, there are not only no national or local boundaries to contain the scene ol a crime and determine the method of its prosecution, there are no clear cultural agreements on what a crime might be': John Perry Barlow 'Selling Wine Without Bottles: The Economy of Mind an the Global Net', www.eff.org/pub/Inteilcctual_propcrty/idea_cconomy.article.

Barlow is not, however, a subscriber to the Cyberspace fallacy, recognising that the competing claims of national law to control the Internet will raise the kinds of problems discussed in this chapter, although he takes the view that a separate law of Cyberspace should, and perhaps will, be developed. Barlow's collected writings on the subject ot law and the Internet, archived at www.cff.org, arc well worth examination.

[49] For an illuminating discussion of the advantages of establishing cyberspace as a separate jurisdiction, ser Johnston and Post M..IW And Borders - The Rise of Law in Cyberspacc' (1996) 4H Stan I.R 1367

transaction is effected, all have a real-world existence and are located in one of more physical world legal jurisdictions. These corporeal elements of cyberspace are sufficient to give national jurisdictions a justification for claiming jurisdiction over, and the applicability of their laws to, an Internet transaction.

The principles used to localise activities for private international law purposes are comparatively simple. In the physical world, localisation is most commonly achieved by examining the geographical location where a human actor was situated when that person performed a relevant act. For legal persons such as corporations, which may be 'present' in multiple jurisdictions simultaneously, the rules of private international law make various presumptions based on the location of the corporate seat, head office, or a branch or trading office.

For contracts, the normal rule is that the applicable law and jurisdiction are those agreed in the contracts[50] However, this is subject to various exceptions, the most important of which are:

- different rules often apply where one of the parties is a consumer[51]; and
- Irrespective of any choice of law, mandatory rules of the otherwise applicable national law will still apply.[52]

Where there is no agreement on applicable law and/or jurisdiction, localisation is achieved on the basis of apparently objective factors, which include:

- the habitual residence of the person who is to make characteristic

[50] See eg Rome Convention on the Law Applicable to Contractual Obligations, art 3; Hague Convention on the Law Applicable to Contracts for the International Sale o'f Goods, art 7; Council Regulation 44/2001/EC on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, OJ L12 p 1, 16 January 2001 (Brussels Regulation), art 23.
[51] See eg Council Regulation 44/2001/EC on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, OJ L12 p 1, 16 January 2001 (Brussels Regulation), arts 15-17.
[52] Eg Rome Conversion on the Law Applicable to Contractual Obligations, art 5(2).

performance;[53]

- the principal place of business of the person who is to make characteristic performance;[54]
- the place where the contract is to be performed;[55]
- the place where the steps necessary for the conclusion of the contract were taken;[56]
- the place where an advertisement or invitation to enter into the contract was received or to which the offerer directed his commercial activities;[57] and
- the place where a branch, agency or other establishment is situated, if the litigation arises out of its activities[58].

For tortious claims the rules are much simpler. Jurisdiction is normally available in every jurisdiction where damage occurred as a result of the tort[59], although it is often only possible to sue in that jurisdiction for the losses suffered there[60], and the

[53] Rome Conventiormn the Law Applicable to Contractual Obligations, art 4(2).

[54] Rome Convention o\the Law Applicable to Contractual Obligations, art 4(2); Hague Convention on the Law Applicabikto Contracts for the International Sale of Goods, art 8(I).

[55] Hague Convention on she Law Applicable to Contracts for the International Sale of Goods, art 8(2) (b); Council Regulation 44/2001/EC on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, OJ L12 p !, 16 January 2001 (Brussels Regulation),

art 5(1).

[56] Rome Convention on the Law Applicable to Contractual Obligations, art 5(2); Hague Convention on the Law Applicable to Contracts for the International Sale of Goods, art 8(2)(a).

[57] Rome Convention on the Law Appltoble to Contractual Obligations, art 5(2); Council Regulation 44/2001/EC on jurisdiction and tn^recognition and enforcement of judgments in civil and commercial matters, O] LI2 p 1, 16 Januato2001 (Brussels Regulation), art 15(l)(c); *ZippoMfg Co v Zippo Dos* Com/nr952 F Supp U19(W4JPa 1997).

[58] Council Regulation 44/2001/EC on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, OJ L12 l6 January 2001 (Brussels Regulation), art 5(5).

[59] Eg Council Regulation 44/2001/EC on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, Ol LI 2 p 1, 16 January 2001 (Brussels Regulation) art 5(3).15 Case C-68/93 *Slievill v Pmse Alliance* 119951 2 AC 18

15. Case C-68/93 *Slievill v Pmse Alliance* 119951 2 AC 18

applicable law will normally be that of the jurisdiction in which the tort was committed[61].

There are fundamental difficulties in applying traditional localisation principles to a transaction which is effected via the Internet. Doing so requires an identification of the physical place where the appropriate element of the transaction occurred, as a consequence of which jurisdiction is awarded to the state in whose territory that place is located, or its law is applied.

This produces workable answers for most physical world transactions. As we shall see, however, the likely result of applying the concept of localisation to an electronic commerce or Internet transaction is either:

- the applicable law or jurisdiction is potentially that of every country in the world; or
- the applicable law or jurisdiction is purely fortuitous, and has no obvious connection with the parties or the substantive transaction.

This can be demonstrated by applying the localisation principles of the various international conventions on private international law to examples from real-life electronic commerce or Internet transactions.

(1) **Place of supply of goods, services or performance of principal obligation**

There are numerous provisions in the conventions relating to the applicable law or jurisdiction for contracts which specify the place of supply as a localisation trigger.[62]

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[61] This is approximately correct for civil law jurisdictions and for the UK if the Brussels or Lugano Conventions apply - Dicey and Morris *The Conflict of Laws* (London: Sweet & Maxwell, 13th edn, 2000) paras 11-002 and 11-003. See also *Bmzovsky v Forbes Inc*(1998) Times, 27 November

Whether a sensible result is produced depends on the subject-matter of the contract. Thus, where the contract is to supply physical goods (ie the electronic commerce transaction is simply an equivalent channel to mail or telephone ordering) the localisation of the contract presents no special problems; the relevant place is the address for delivery of the goods.

However, the position is quite different if the contract is for a 'product' which is to be delivered electronically. The most obvious of such products are on-line services, and information products (eg software, images, music, video or games). For these, the place of supply is hard to define. The options are as follows:

1) The place of electronic 'delivery'. Delivery of information products and services is an elastic concept, which depends very much on the supply technology used. For example

⇨ If the product is sent as an email attachment, its place of receipt will probably[63] be determined in the same way in which the courts would decide where a contractual acceptance was received. Taking the example of a purchaser who is employed in London by a multinational corporation whose domain name points initially to a server in the US,[64] there are at least four possible places of receipt:

- If the place of receipt is the moment the message enters the

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[62] Sec note 10 ante.

[63] So far as the author is aware, there is as yet no judicial decision in any jurisdiction which has had to decide this point. However, courts tend to look for analogous situations, and in most jurisdictions the question of place and time of receipt of contractual communications has received extensive judicial attention, and some states have enacted legislation which clarifies the law for electronic communications - see below.

[64] Most multinationals operate their email systems in a similar way, pointing their domain names at their primary IT centre and then routing received emails internally to the various countries of receipt. Staff may use the system to contract in their employee capacity and possibly also their consumer capacity, subject to their employer's rules on use of the system.

corporation's systems (as would probably be the case under eg art 1335 of the Italian Civil Code), the relevant location would be the US, ie the physical location of the server to which the corporation's domain name points. We must also note that this server could at any time be moved to a different physical location, in any jurisdiction, without affecting the operation of the email process[65] and without the sender or recipient realising the fact.

- As a related alternative, the place of receipt might be the registered head office of the corporation, ie the place of domicile or residence of the virtual 'office' to which the email was addressed.
- If the place of receipt is at the purchaser's mailbox, this would probably be located on a UK-based server to which the email is routed by the corporation's internal network. However, there is no technical reason why the corporation might not, without this being apparent to the purchaser or the vendor, physically relocate that server to eg Guatemala. The system would perform in an apparently identical way so far as both parties are concerned.
- If the product is 'collected' by the purchaser from the supplier's website, there is a strong argument that delivery occurs at that website.[66] This may not be in the supplier's jurisdiction of establishment; many electronic commerce enterprises adopt a distributed mode of operation, locating eg the advertising website in one jurisdiction, the stock catalogue in another, the payment

[65] Provided, of course, that the DNS record for that domain name were updated to map the domain name to the new IP address of that server.

[66] The purchaser makes his *own* arrangements for collection, using the Internet technologies to do so. This is analogous to the free on board contract used for international shipping trade.

processing system in a third and the server from which information products are delivered in a fourth.

- If the place of receipt is where the purchaser actually downloads and/or reads the email, that could occur in whichever jurisdiction he happened to be located when the email was collected from the mailbox. The place of downloading and the place of reading could also be different, eg if the purchaser downloads email to a laptop in London but does not read it until arrival in Paris. The Australian Electronic Communications Act 1999 does not deal with this issue directly, but offers two possible analogies by making provision in s 14 for the time and place of receipt of an electronic communication[67]. Time of acceptance is either the entry of the communication into the system denoted by the recipient (eg the email host) or, if none is designated, the time when the communication actually comes to the attention of the recipient. In the context of the Internet the second option will rarely apply, as it is usually impossible to communicate with a person without knowing the address of the relevant system.[68]

2) Place where purchaser took steps towards contract formation

The place where the purchaser took these steps may be one of the jurisdictions in which an action can be brought, though often only if the purchaser is habitually resident there[69]. At first sight this presents fewer difficulties, as the physical location

[67] See also the US Uniform Electronic Transactions Act 1999, § 15(b) and (d), which contains almost identical provisions.
[68] Presumably, however, it would apply loan unsolicited communication (irrelevant in the context of delivery of electronic products or services) and to a person communicating via an anonymous remailer or surfing the World Wide Web via an anonymising service (see further Chapter 2.3.3.3).
[69] See note 11 ante.

of the purchaser can usually be determined with some certainty. Even here, however, problems can arise:

- The purchaser begins the transaction in one jurisdiction and completes it in another. Some electronic commerce suppliers allow customers to store partial orders and return to them at a later date to complete the order.
- The purchaser is 'visiting' a website in a different location, and the applicable law (an equally difficult question) determines that the contract forming actions took place on that website, and not at the user's computer.

3) State where suppliers branch agency, etc is established

In the field of regulated services, such as banking and financial services[70], some commentators have suggested that whenever a person accesses the supplier's website, a temporary, virtual branch is created. If this argument is accepted, it means that each electronic commerce business has, at some time or other, established a branch in every jurisdiction of the world where Internet access is possible. All that would be necessary to establish jurisdiction in a particular state under art would be to prove a single access to the website from that state.

The European Commission has rejected this argument in a consultation document relating to the Second Banking Directive[71], but the document is merely explanatory and does not establish the legal position even in respect of banking services. It is not

[70] Sec part 7.2 below.
[71] *Freedom to provide services and the interest of the general good in the second bunking directive* Commission interpretative communication SEC(97) 1193 final, 20 June 1997.

possible to predict whether a court would find this argument attractive. However, it may be worth noting that in a criminal action based on obscene content, a Tennessee court found that it had jurisdiction over a Califonian bulletin board on the basis of a proved access to the board from Tennessee.[72]

Targeting

An approach which at first sight seems attractive is to grant jurisdiction to those jurisdiction whose residents are targeted by the supplier. The justification for this approach is that the supplier is seeking customers in that jurisdiction, and can thus hardly complain if its courts claim jurisdiction over his activities. This has similarities to the US 'minimum contacts' doctrine, which was explained in CompuServe v Patterson[73] as follows:

> As always in this context, the crucial federal constitutional inquiry is whether, given the facts of the case, the nonresident defendant has sufficient contacts with the forum state that the district court's exercise of jurisdiction would comport with "traditional notions of fair play and substantial justice". International Shoe Co. v. Washington, 326 U.S. 310, 316 (1945) (quoting Milliken v Meyer, 311 US 457, 463 (1940)); Reynolds, 23 F.3d at 1116; Theunissen, 935 F 2d at 1459. This court has repeatedly employed three criteria to make this determination: First, the defendant must purposefully avail himself of the privilege of acting in the forum state or causing a consequence in the forum state. Second, the cause of action must arise from the defendant's activities there. Finally, the acts of the defendant or

[72] *United States v Thomas* F 3d 701 at 706-707 (6th Cir, 1996).
[73] 89 F 3d 1257 (6th Cir, 1996).

consequences caused by the defendant must have a substantial enough connection with the forum to make the exercise of jurisdiction over the defendant reasonable.

In CompuServe v Patterson the defendant used the CompuServe system, located in Ohio, from which to sell software, and for this reason was held subject to Ohio jurisdiction.

This immediately raises the question whether a website, which by definition can be accessed world-wide, amounts to 'activities' in those jurisdictions in which it is accessible. The US courts appear to have answered this question by making a distinction between an 'active' website, which solicits those outside the jurisdiction to undertake a commercial transaction with the website owner, and a 'passive' website which merely provides information. The former is sufficient to satisfy the minimum contacts doctrine[74] whereas the latter is not.[75]

The European Commission has taken a similar approach in the Brussels Regulation, so far as consumer contracts are concerned:

ARTICLE 15

1. In matters relating tqa contractconcluedy a person, the consumer, for a purpose which can be regarded as being outside Jjjg.trade.Qr pro&jgiiyi, jurisdiction shall be determined by this Section, without prejudice to Article 4 and point 5 of Article 5, if:

[74] *Maritz Inc v Cybergold Inc* 947 F Supp 1328 (ED Mo, 1996); *Zippo Mfg Co v Zippofot Com Inc* 952 F Supp 1119 (WD Pa 1997).
[75] *Bensitsan Restaurant Corp v King* 937 F Supp 295 (SONY, 1996) aff'd 126 F 3d 25 (2nd Cir, 1997). 'The mere fact that a person can gain information on the allegedly infringing product is not the equivalent of a person advertising, promoting, selling or otherwise making an effort to target its product in New York.' See also *Cybersell Inc v Cybersell Inc* 130 F 3d 414 (9th Cir, *1997); Hornelt Brewing Co v Rosebud Sioux Tribal* O 133 F 3d 1087 (8th Cir, 1998). However, in *Inset Sys Inc v instruction Set Inc* 937 F Supp 161 (D Conn, 1996) the court held that Internet advertising coupled with a toll-free telephone number was sufficient targeting of the court's state to give it jurisdiction. This case appears to be anomalous, though, and numerous other cases have followed the *Bemv.san* approach

(c) in all other cases, the contract has been concluded with a person who pursues commercial or professional activities in the Member State of the consumer's domicile or, by any means, directs such activities to that Member State or to several States including that Member State, and the contract falls within the scope of such activities.

ARTICLE 16

1. A consumer may bring proceedings against the other party to a contract either in the courts of the Member State in which that party is domiciled or in the courts for the place where the consumer is domiciled.
2. Proceedings may be brought against a consumer by the other party to the contract only in the courts of the Member State in which the consumer is domiciled.

This drafting has been criticised on the ground that art 15 is based on an unrealistic view of electronic commerce, i.e. that websites can easily be classified into 'active' and 'passive'. In practice, an electronic commerce supplier will wish to sell to customers in some jurisdictions, but not others, and to do this from the same website. The result is likely to be that all jurisdictions are deemed to be targeted, unless complicated and costly steps are taken to partition the website into purely national elements. Simple disclaimers that the site is not open to dealings with consumers in a particular country will probably be insufficient [76]unless steps are also taken to

[76] See Mike Pullen 'On The Proposals To Adopt The Amended Brussels Convention And The Draft Rome II Convention As EU Regulations Pursuant To Article 65 Of The Amsterdam Treaty' *EU Version* - Position Paper Prepared For The Advertising Association (www.ilpf.org/events/jurisdiction/presentations/pullen.posit.htm), paras 1.9-1.12. However, the British Columbia Securities Commission decided in 2002 that an investment advice website which disclaimed the availability of particular services to British Columbia residents, but made them available to US residents, was acceptable as complying with the British Columbia regulatory requirements

prevent consumers from viewing the advertising without certifying that they are not from the disclaimed jurisdiction.

4) Place of commission of a tort, or place of injury resulting from the tort

The normal rule is that both these states (if different) have jurisdiction over an action in respect of the tort, though the applicable law will normally be the place where the tort is committed.[77] For torts committed via the Internet, this often produces the answer that the place of commission and/or the injury occurs everywhere.

To take defamation as an example, suppose that a defamatory message is posted to a newsgroup as occurred in the UK case of Godfrey v Demon Internet Ltd.[78] Each ISP which hosts that newsgroup has a copy of the database containing the newsgroup postings on its servers. Several times a day that copy is collated with the database of the newsgroup held on another ISP's server, each passing over and receiving postings which are not contained in the other copy. As a result, any posting propagates across the Internet until, within a few hours, it appears in every copy of the newsgroup database.

Because the tort occurs, and the injury is suffered, in every jurisdiction in which the posting is published, and the defendant who posted the message is responsible for

- Pan Geo Investment Inc and Gary Hamill (2002) BCSECCOM 435. It appears, however, that a relevant consideration was that the website proprietor had expressed a willingness to comply with any other requirements imposed by the regulator to assist in preventing the impermissible types of advice being given the British Columbia residents: para 38.

[77] See notes 14-16 ante. The position in civil law jurisdictions is examined in Law Commission Working Paper no 87 *Private International taw: Choictoflaw in Tori and Delict (*1984), Appendix. The US adopts a different approach, applying the law of the jurisdiction with the closest connection to the tort - Restatement (Second) on the Conflict of Laws (1972) § 145

[78] [1999] 4 All ER 342. See further Chapter 4.2.3.1.

the expected further transmission of his initial publication, localisation for this tort occurs:

- in every jurisdiction where an ISP hosts the newsgroup; and
- in every jurisdiction where a subscriber reads the defamatory posting. It is technically possible for a subscriber in one jurisdiction to access a newsgroup hosted on a server in another jurisdiction, although in practice some (but by no means all) ISPs only allow their own subscribers to access the news server.

In this example, the tort is probably committed almost everywhere in the world, and injury suffered everywhere also. The Australian courts have already decided in Dow Jones & - Co Inc v Gutnick[79] that defamation via a website occurs in each place from which the website is accessed.

Similar results can be found for other torts based on 'broadcast' information, such as torts of property damage arising from computer viruses (assuming that the applicable law recognises damage to information as falling within the tort).[80]

Alternative approaches

These examples demonstrate that localisation is often a meaningless concept in relation to electronic commerce and the Internet. This is because the communications infrastructure is intentionally flexible-every Internet resource is available from everywhere. Each individual transaction via the communications network

[79] 12002] HCA 56, |2003| 1 LRC 368, Aus HC - sec Chapter 4.2.3.2.
[80] Eg the UK Computer Misuse Act 1990, s 3 crealcsa criminal offence of unauthorised modification of dam, and most criminal offences of this lyic also amount to torts

potentially uses a different part of the fixed infrastructure (the servers and their communications links), and that fixed infrastructure is often neither owned nor operated by its commercial users.

Some suggestions have been made that a different form of localisation should be considered, based on the physical location of the server used in the transaction or the physical place from which a person (eg a tortfeasor) accessed a server (usually described as the place of'uploading'). This attempt at localisation is equally likely to fail for the reasons described above. Two simple examples may suffice:

- An information resource may be delivered from a choice of servers, determined purely automatically. For example, if a file is requested from ibm.com, it is quite likely thnt it exists in multiple copies on servers in different jurisdictions, and the delivery server is determined by software which is conducting load balancing on IBM's network. To add further complication, the user's ISP may already have a copy of the file, stored in a cache on its own server, and may use that copy to deliver the file.
- The place of uploading has no necessary connection with any contract or tort. For example, X might 'upload' a computer virus to a server, but not make it accessible to others. Y might then change the access permissions to the file containing the virus. In this case, X commits no tort (unless he is a co-conspirator with Y). Y commits the tori, but never uploads the virus file.

There are no obvious solutions to this problem. One possibility, whose only virtue is its workability, is a bright line rule that jurisdiction exists only in the places of

habitual residence of the parties to the action. There are many objections to this rule on other grounds, the most cogent being that the solution has no theoretical basis but is merely expedient. In addition, such a rule would not satisfy the US Constitution's requirement for due process in asserting jurisdiction, which has led to the 'minimum contacts' doctrine discussed in part 7.1.3.4 above. As yet, it is not possible to predict how the law in this area will develop.

In theory there is no limit on the circumstances in which a national Government might claim to apply its laws and regulations to Internet activities which originate in a different jurisdiction, although practical enforcement of those laws against a foreign enterprise is a different matter. In practice, however, Governments attempt to limit the extraterritorial effect of their laws by applying the principle of comity[81], thus reducing the risk of legislative 'arms races'. In essence, comity requires that a state should not claim to apply its legislation to persons within another state unless it is reasonable to do so, which normally means that legislation should be undertaken by the state which has the greater interest in so doing.[82]

The most common way in which legislators attempt to maintain comity is to apply their laws only to activities undertaken within the state[83]. This is a form of localization however, localisation for the purpose of applying local law and regulation uses some different localisation triggers from those already examined, and so merits further discussion.

[81] The US Supreme Court has defined comity as 'the recognition which one nation allows within its territory to the legislative, executive, or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protections of its law': *Hilton v Guyot* 115.US 113 at 163-164 (1995).

[82] See eg Restatement (Third) of Foreign Relations Law of the United States, § 403(1) (1987).

[83] If this were universally applied there would be no problem of multiple and overlapping national regulation, as the activity to which the regulation applied would only have occurred in brie jurisdiction. However, for obvious reasons states commonly also apply their laws and regulations to the *effects* in the jurisdiction of activities carried out elsewhere.

Increasingly, there is a recognition that localisation on the basis of Internet activities is inappropriate, and that some alternative basis for maintaining comity must be found. The most promising alternative seems to be that of accepting 'country of origin' regulation, coupled with an appropriate degree of harmonisation or convergence of national laws.

Activities undertaken in the jurisdiction

One of the most heavily regulated areas of commercial activity is financial services (including banking), and because this is an activity which consists almost exclusively in the transfer and management of information it is ideally suited to electronic commerce via the Internet. As a consequence, many of the problematic issues of regulatory competence have already become apparent, and suggestions have been made for resolving them. Similarly, the implications of electronic commerce for the collection of income and sales taxes have also been investigated by national and international bodies. For this reason, most of the examples examined in this part of the chapter will be drawn from financial services and income tax regulation.

In the field of financial services and taxation law, there are three main localization triggers used to determine whether national law applies:

- whether the enterprise has an establishment in the national territory;
- whether it is doing business by offering services in or deriving income from transactions in that territory; or
- whether it is advertising its services to potential customers in that territory.

a) Establishment

Having a permanent establishment in the relevant jurisdiction is the primary trigger for the application of financial services regulation[84] to, and the imposition of income tax liability on[85], a commercial enterprise. Establishment is a somewhat elastic concept, however. Even in the physical world, it is possible to undertake trading activities in another state through the means of agents, or through distance selling techniques such as telephone marketing which do not require the business to occupy premises or possess business equipment located in that state.

[84] See eg UK Financial Services and Markets Act 2000, s 418:'(1) In the four cases described in this section, a person who - (a) is carrying on A regulated activity, but (h) would not otherwise be -regarded as carrying it on in the United Kingdom, is, for the purposes of this Act, to be regarded as carrying it on in the United Kingdom. (2) The first case is where - (a) his registered office (or if he does not have a registered office his head office) is in the United Kingdom; (b) he is entitled to exercise rights under a single market directive as a UK firm; and (c) he is carrying on in another EEA State a regulated activity to which that directive applies. (3) The second case is where- (a) his registered office (or if he does not have a registered office his head office) is in the United Kingdom; (b) he is the manager of a scheme which is entitled to enjoy the rights conferred by an instrument which is a relevant Community instrument for the purposes of section 264; and (c) persons in another EEA State are invited to become participants in the scheme. (4) The third case is where - (a) his registered office (or if he does not have a registered office his head office) is in the United Kingdom; (b) the day-to-day management of the carrying on of the regulated activity is the responsibility of- (i) his registered office (or head office); or (ii) another establishment maintained by him in the United Kingdom. (5) The fourth case is where -(a) his head office is not in the United Kingdom; but (b) the activity is carried on from an establishment maintained by him in the United Kingdom. (6) For the purposes of subsections (2) to (5) it is irrelevant where the person with whom the activity is carried on is situated.'

[85] OECD Model Tax Convention on Income and on Capital (28 January 2003) art 7(1). See also *Tax and the Internet* Discussion report of the Australian Taxation Office Electronic Commerce Project Team on the challenges of electronic commerce for tax administration (Canberra: Australian Government Publishing Service, August 1997) paras 7.2.2 and 7.2.3:

'The legal basis of tax jurisdiction is premised on taxation concepts such as residency, source and permanent establishment.... All of these concepts have an important element of physical or territorial nexus with Australia. In simple terms, the primary test for individual residents is that they physically reside in Australia. For companies the tests are that they are incorporated in Australia or carry on business in Australia and are centrally managed and controlled from Australia. Australian sourced income often includes income that is derived from a physical place in Australia and a non-resident business is considered to have a permanent establishment in Australia if it has a "fixed place of business" in Australia (in termsofboth timing and geography).

In the context of banking services, the European Court of Justice has attempted a definition of establishment in the Somafer case:[86]

The concept of branch, agency or other establishment implies a place of business which has the appearance of permanency, such as the extension of a parent body, has a management and is materially equipped to negotiate business with third parties, so that the latter, although knowing that there will if necessary be a legal link with the parent body, the head office of which is abroad, do not have to deal directly with such parent body but may transact business at the place of business constituting the extension.

In essence this ruling sets out three requirements, which are also reflected in other areas of regulation:[87]

- the use of fixed premises or equipment in the state;
- the presence of staff (which may include some intermediaries who act as agents for the enterprise); and
- the ability of those staff to undertake business transactions with customers in the state.

Immediately, it can be seen that if this interpretation of the concept of establishment is applied to Internet activities from a foreign jurisdiction, the fact that the supplier's website appears (temporarily) on the customer's computer will not he-sufficient to create a virtual branch. The supplier has no premises or staff in the jurisdiction, and the computer equipment is used only temporarily and in any event belongs to the customer.

[86] Case 33/78 *Somafrr SA v Saar-Ferngas AC* [1978] F.CR 2183
[87] See eg Minister of National Revenue's Advisory Committee on Electronic Commerce *Electronic Commerce and Canada's Tax Administrati'on* (April 1998) s 4.2.2.4.

A more difficult issue arises, however, if the supplier's website is stored on a server in the jurisdiction.[88] Even if the website runs from a server owned by the supplier, located in premises owned or rented by him, and maintained by his employees, not all the requirements of a permanent establishment are met. There are still no staff in that jurisdiction who have authority to contract with customers - that function is performed by software running on the server.

So far as banking services are concerned, the European Commission appears to have accepted this argument:[89]

Freedom to provide services and the intereft of the general good in the second banking directive, Commission interpretative communication SEC (97) 1193 final 20 June 1997

Unlike other services, where the place of supply can give rise to no doubts (legal defence, construction of a building, etc.), the banking services listed in the Annex to the Second Directive are difficult to pin down to a specific location. They are also very different from one another and are increasingly provided in an intangible form.

[88] Operating from multiple websites can be a sensible electronic commerce strategy because of the communication bottlenecks which arise as Internet traffic crosses difficult geographic boundaries, such as oceans. A global electronic commerce supplier might well choose to operate websites in each of the major continents for precisely this reason

[89] See also *Commission proposal for a European Parliament and Council directive on certain legal aspects of electronic commerce in the internal market* COM (1998) 586 final, 98/0325 (COD), 18 November 1998, explanatory memorandum, p 20: 'Thus, the following, for example, do not amount to an establishment on the territory of a Member State: - the location of the technology used, e.g. the hosting of web pages or of a site; - the ability to access an internet site in a Member State (any other approach would mean that an operator would be considered to be established in several or indeed fifteen Member States); - the fact that a service provider established in another Member State offers services targeted at the territory of another Member State (in fact, the internal market enables businesses, particularly SMEs, to tailor their offers to specific niche markets in other Member States).'

US bank regulation was amended in 2002 to adopt the same localisation principle- see 12 CFR § 7.5008: 'A national bank shall not be considered located in a State solely because it physically maintains technology, such as a server or automated loan center, iu that state, or because the bank's products or services are accessed through electronic means by customers located in the state.

The growth of distance services, particularly those using electronic means (Internet, home banking, etc.) will undoubtedly soon result in excessively strict criteria on location becoming obsolete.

It is not always easy to draw the line between the concepts of provision of services and establishment, particularly since, as the case law of the Court indicates, one may be considered in certain circumstances to be operating in a Member State under the freedom to provide services despite having some kind of infrastructure in that Member State. Some situations are particularly difficult to classify. This is especially true of:

- recourse to independent intermediaries; and
- electronic machines (ATMs) carrying out banking activities.

(b) Electronic machines

This means fixed, ATM type electronic machines capable of performing the banking activities listed in the Annex to the Second Directive.[90]

Such machines may be covered by the right of establishment if they fulfill the criteria laid down by the Court of Justice (see above). For such a machine to be capable of being treated as an establishment, therefore, it would have to have a management, which is by definition impossible unless the Court acknowledges that the concept can encompass not only human management but also electronic management.

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[90] It 'does not mean individual, mobile dato-proccssing equipment which can provide or receive distance banking services, eg through the Internet

The presence in the host country of a person or company responsible simply for maintaining the machine, equipping it and dealing with any technical problems encountered by users cannot rank as an establishment and does not deprive the credit institution of the right to operate under the freedom to provide services.

The Commission considers, however, that technological developments could, in the future, induce it to review its position.

If such developments were to make it possible for an institution to have only a machine in a given country which could 'act' as a branch, taking actual decisions which would completely obviate the need for the customer to have contact with the parent company, the Commission would be forced to consider an appropriate Community legal framework. The present legal framework in fact rests on mechanisms which are still based on a 'human' concept of a branch (for example, the programme of operations must contain the names of those responsible for the management of the branch). It is therefore not possible, under the existing rules, to consider machines as constituting a branch.

The last paragraph of this extract recognises that Internet banking websites can act autonomously, as replacements for physical branches. However, there is no urgent need for legislation to preserve the regulatory competence of, national regulators because this is based on either establishment or offering banking services in the jurisdiction.

The concept of establishment is more critical for income tax purposes, however. Tax laws commonly provide that a business is only liable to income-related[91] taxes in a

[91] Including corporation taxes

foreign jurisdiction if it is resident or has a permanent establishment there,[92] or that if it has no establishment it is only liable to tax on profits from business activities undertaken in (not with) the jurisdiction.[93] For this reason, it is likely that the tax authorities will wish to take a more restrictive view of website hosting.

The definition of permanent establishment for tax purposes, so far as physical world activities is concerned, is very similar to that discussed above; it requires premises or equipment, or employed staff acting on behalf of the enterprise in its transactions with customers.[94] Working Party No. 1 on Tax Conventions and Related Questions of the OECD Committee on Fiscal Affairs has proposed that for income tax purposes, a website hosted on a server where the server is a business asset of the enterprise should be treated as a permanent establishment of the enterprise. However, if the website is merely hosted by an independent 1SP, because there is no

[92] OECD Model Tax Convention on Income and on Capital (28 January 2003), art 7(1): 'The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment

[93] This is the current position under UK law-see further Chissickand Kelman Eertro Kic Commerce: *Law and Practice* (London: Sweet & Maxwell, 1999) Chapter 9.15-9.17.

[94] See eg OECD Model Tax Convention on Income and on Capital (28 January 2003) art 5:' 1. For the purposes of this Convention, the term 'permanent establishment' means a fixed place of business through which thebusiness of an enterprise is wholly or partly carried on. 2. The term 'permanent establishment' includes especially: a) a place of management; b) a branch; c) an office;... 4. Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include: a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery; c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; d) the maintenanceof a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise; e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; f) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. 5. Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to whom paragraph 6 applies -is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.'

equipment or premises controlled exclusively by the enterprise it would have no permanent establishment in the jurisdiction.

What is clear, however, is that unless the concept of permanent establishment is modified radically, an enterprise whose website is not located in the jurisdiction will not be subject to the regulation of that jurisdiction via the 'virtual branch' theory. More likely, local regulation will apply (if at all) because the enterprise does business there.

b) Doing business in the jurisdiction

Most financial services regulations apply not only to activities from a permanent establishment in the jurisdiction, but also to specified activities carried out there by other means. The difficulty lies in deciding where precisely these activities take place when they are effected through electronic communications. A similar problem can arise for sales of physical goods via the Internet, as in many instances those contracts may be formed outside the buyer's jurisdiction,[95] although the problem is less intractable because the fundamental performance, delivery of the goods, takes place within the jurisdiction.

The core element of all financial services activities, with the exception of giving financial advice[96], is the manipulation of account data. This is true for eg bank

[95] See Chapter 6.2.I.I.

[96] It is arguable that advice is given where it is received, as until that point it is merely potential advice. However, we have already noted that for VAT purposes advice would be treated as a service provided in the advisor's jurisdiction, were it not for the reverse charge provisions of VAT law - see note 28 above. The UK courts have established that the giving of advice by means of software, running without further intervention on the part of the author, is nonetheless given by the author - *Re Market Wizard Systems (UK) Ltd* 11998] 2 BCLC 282 - and it has been suggested that the same reasoning should apply to make the operator of a website liable for advice given via automated means from that website - Lars Davies 'From uncertainty to uncertainty: Developments in securities law and the Internet in the United Kingdom" (1999) 12(5) Compliance Monitor at 71

account transactions, share dealings[97] and dealings in investment funds. Although there maybe underlying 'real' assets[98], the service consists in transmitting messages and modifying account data. Thus if a bank customer uses the Internet to instruct his bank to pay a bill, the required service is the transmission by the bank of an appropriate payment message and the consequential amendment of the customer's account data. Both of these activities take place on the bank's computers, in the bank's jurisdiction.[99]

From a regulator's perspective this might appear undesirable, as such an approach would permit a business which could operate purely via electronic communications to establish itself abroad, but sell its services within the regulator's jurisdiction without being subject to the regulator's control. For this reason, some national laws have been structured in such a way as to extend the regulator's jurisdiction.

Thus, eg the UK Financial Services and Markets Act 2000 deals with this problem of deciding where a business activity takes place by extending the range of business activities covered. The basic prohibition is set out in s 19(1) of the Act, which provides that 'No person may carry on a regulated activity in the United Kingdom,

[97] At least on modern dematerialized securities exchanges, where the dealings are in undifferentiated quantities of shares from nominee accounts rather than numbered shares identified by physical certificates - see eg UK Uncertificated Securities Regulations 1995, SI 1995/3272.

[98] Though even in terms of assets, most are 'unreal' in the sense that they are merely debts, evidenced by data relating to another account. Typical examples for a bank include loans made to its customers (eg mortgages) and Certificates of Deposit with the central bank

[99] See *Freedom to provide services and the interest of the general good in the second banking directive Commission* interpretative communication SEC(97) 1193 final, 20 June 1997, pp 6-7: 'The growth of distance services, particularly those using electronic means (Internet, home banking, etc.), will undoubtedly soon result in excessively strict criteria on location becoming obsolete. The Commission has examined certain possibilities for locating the service (originator ' of the initiative, customer's place of residence, supplier's place of establishment, place where contracts are signed, etc.) and considers that none could satisfactorily apply to all the activities listed in the Annex. It considers it necessary to adhere to a simple and flexible interpretation of Article 20 of the Second Directive. Accordingly, in its opinion, only activities carried on *within the territory* of another Member State should be the subject of prior notification. In order to determine where an activity was carried on, the place of provision of what may be termed the "characteristic performance" of the service, i.e. the essential supply for which payment is due must be determined.... the provision of distance banking services, for example through the Internet, should not, in the Commission's view, require prior notification, since the supplier cannot be deemed to be pursuing its activities in the customer's territorv.'

or purport to do so, unless he is - (a) an authorised person; or (b) an exempt person'. Schedule 2 of the Act sets out a list of eight regulated activities:

- Dealing in investments.
- Arranging deals in investments.
- Deposit taking.
- Safekeeping and administration of assets.
- Managing investments.
- Giving investment advice.
- Establishing collective investment schemes.
- Using computer-based systems for giving investment instructions.

If the prohibition merely covered performing these activities, then in most cases performance would occur on the seller's server and thus potentially outside the UK. However, Sch 2 expressly states that, with the exception of deposit taking, performance of all these activities includes offering or agreeing in the UK to undertake the activity. Thus, unless the seller can structure his operations so that no offer or agreement takes place in the UK, the UK regulator will have jurisdiction over an Internet supplier of financial services.

Tax law takes a different approach. As we have seen, income-related taxes are normally only payable if business is undertaken through a permanent establishment. However, the position is different for indirect taxes. To avoid the migration of service business to low-tax jurisdictions, the EU has made specific provision in its Value Added Tax laws which deems the service to have been supplied in the recipient's jurisdiction, and thus at the recipient's VAT rate.

Further provisions, known as the 'reverse charge' principle, deal with the problem of tax collection by deeming the recipient to have made a taxable supply of services to himself,

Either of these techniques can be used by national legislators to grant jurisdictional competence to their national regulators over Internet businesses which attract customers from the jurisdiction. However, there is a clear and important distinction to be made between the applicability of a law and its enforcement. Enforcement is normally only practicable where the defendant has personnel or assets within the jurisdiction.

c) Advertising

Advertising controls are extensive in most jurisdictions,[100] and present a real problem for commercial users of the Internet. By definition, an intended commercial communication will not become an advertisement until it is read (or at least readable) by potential customers. It is this act of communication which constitutes advertising, and the only logical conclusion is that the advertising takes place where the potential customer sees the communication. In the case of a Web page advertisement, that place is the reader's computer, and thus the jurisdiction where the reader is physically located. The law which regulates that particular instance of the advertisement will therefore be the law of the place of reading.

For comparatively uncontroversial products, such as books on Internet law, it may be possible to produce a Web advertisement which is likely to comply with most, if not all, the applicable advertising laws by being truthful and accurate. However, in

[100] Sixth Council Directive of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes (Directive 77/388/EEC), art 21(l) b).

highly regulated sectors such as financial services it is usually a criminal offence to issue an advertisement, irrespective of its truth and accuracy, unless the issuer is authorised by the national regulatory body[101]

The difficulty which provisions present to Internet financial services suppliers is that, to be 'legal', they in theory need to register with every supervisory authority in the world! The consequences of failure to register usually include criminal sanctions, and any transaction entered into with customers in that jurisdiction may be unenforceable.[102]

Even regulators recognise that world-wide registration is impracticable, although there are as yet no proposals to limit radically the application of the relevant laws. Some regulators have, however, attempted to mitigate the impossibility of the current situation by issuing statements about their enforcement policy, stating that in practice they will not take action against an advertisement unless it is targeted at customers in their jurisdiction

The question which remains to be answered is what 'targeting' consists of. Here there are two possible approaches:

- an advertiser will not be targeting a jurisdiction if the advertisement is not made available to customers in that jurisdiction; or
- even though the advertisement is available, targeting will not have taken place if there are adequate measures to prevent customers from that jurisdiction from purchasing the financial products or services.

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[101] See eg UK Financial Services Authority *Treatment of material on overseas Internet World Wide Web sites accessible in the UK but not intended for investors in the UK Guidance 2/98* (1998): '10....

[102] See eg UK Financial Services and Markets Act 2000. s 28.

The UK Financial Services Authority (FSA) initially adopted the first approach but this was widely criticised as unworkable - in effect, a financial services company would have been required to prevent readers from viewing any part of their website which constituted an investment advertisement under the Financial Services Act 1986 unless the reader certified that he or she was not viewing the site from the UK. The current policy mixes the two approaches, although it still appears to believe that access restriction is a practicable matter.[103]

Country of origin regulation

Country of origin regulation (also known as home country regulation) is the only regulatory model so far attempted which, at least in the author's opinion, is capable of resolving the conflicts between the multifarious and overlapping claims by national jurisdictions to regulate particular Internet activities. The principles of country of origin regulation are simple:

- by mutual agreement two states, or a group of states collectively, provide that activities of an organisation which is established and regulated in one state (the home state) may be carried out in another (the host state) without any requirement for prior authorisation from or supervision by the appropriate regulatory body in the host state;
- the basis of this agreement is an assessment by all participating states that the others operate systems of authorisation and/or supervision which are adequate to achieve the aims of the home state's regulatory system;
- the laws of the host state will still apply:
  - to the appropriate aspects of individual transactions undertaken in the

[103] See particularly note 80 below

state, eg the law of contract or consumer protection law; and

- where the host state's law or regulation has overriding effect, eg the protection of national security.

One of the first, and still the most extensive and well-developed, multilateral schemes of country of origin regulation is the EU 'single passport' for banking services. All the states making up the EEA have implemented national legislation which transposes the First and Second Banking Directives, and other related legislation,90 the net effect of which is to provide a pan-European system under which a credit institution which is established in and regulated by one country is free to provide banking services in all the others. The essence of the system is described in the recitals to the Consolidated Banking Directive:

However, banking and financial services is not the only field of activity where country of origin regulation is being adopted. The developing global infrastructure for electronic signatures, recognises that a Certification Authority will find it unrealistically burdensome to become accredited in each jurisdiction where certificate holders might wish to use electronic signature based on its certificates. Most digital signature laws therefore contain provision for mutual recognition of foreign accreditation schemes, with the result that certificates emanating from a Certification Authority accredited under such a scheme will be given equivalent legal effect to certificates from a locally accredited issuer. Thus the Singapore Electronic Transactions Act 1998, s 20 provides:

It seems likely that as new types of Internet commercial activity are devised which require supervisory regulation, these precedents will lead to similar systems of

country of origin regulation. Directive 2000/31/EC on electronic commerce has already adopted the principle, in arts 3 and 4, as the standard for most electronic commerce activities. Under the Directive an 'information society service provider' established in one Member State may not be made subject to prior authorisation under the laws of another Member State in order to do on-line business there, and the law applicable to its establishment and conduct of business is the law of the home state. The country of reception law applies, in most cases, only to contracts with consumers in that state.94 It is worth noting that much of the non-sector specific consumer protection law has been harmonised within the EU, and good progress is being made in sector-specific harmonisation, so that in practice the differences in national laws relating to consumer contracts will become increasingly minor and thus less of a barrier to on-line commerce.

Because the essence of country of origin regulation is the acceptance by the host country that the home country provides an adequate and broadly equivalent level of regulatory oversight, there are two fundamental issues which any scheme needs to address:

- What are the minimum standards for authorisation and supervision?
- What exceptions to country of origin regulation are permitted? This is particularly important, as there is otherwise a tendency for states to maintain or impose regulatory requirements whose indirect effect is to reserve the home market to those established in and regulated by the home country.

a) Minimum standards for authorization and supervision

Both the banking and electronic signatures implementations of home country regulation recognize four factors as the basis for a set of minimum standards:

- the enterprise must be a fit and proper person to undertake the regulated activity;
- it must be financially sound so as to ensure continued, solvent operation;
- its staff must be properly qualified, adequately trained and well-supervised; and
- its operational and technical systems must be of appropriate quality and adequately maintained and updated.

Because acting as a bank is, in operational terms, quite different from acting as a Certification Authority, in each case it has proved necessary to expand on these fundamental principles in detail. "M However, the principles are only intended to set out the minimum requirements for an international business which is one element of an interconnected infrastructure that is fundamental to the continuance of commercial and private life, rather than to address any particular technology or type of business activity. It thus seems likely that they will prove to be applicable to new Internet activities as they develop.

b) Exceptions to country of origin regulation

The basis of country of origin regulation is not that the regulation by home and host country is the same, but that it is broadly equivalent. It is therefore tempting for a host country to wish to apply certain elements of its own regulatory system to foreign providers of services, notwithstanding multilateral or bilateral agreement

establishing the country of origin principle. An essential element of such agreements is therefore the establishment of the limits on the host country's ability to apply its national regulations. In the EU, whose single market project has resulted in extensive jurisprudence on the topic,101 departure from the country of origin principle is .normally only justified if it is for the general good'.

In the context of the Second Banking Directive, this issue caused so many problems that the European Commission found it necessary to issue a consultation document on the topic, setting out the circumstances in which it would be legitimate to derogate from the principle. An important element in assessing legitimacy is whether the derogation is proportionate, in other words whether there is a less restrictive measure which would achieve the general good objective. The Commission's reasoning is likely to influence future schemes for country of origin regulation.

Freedom to provide services and the interest of the general good in the second banking directive, Commission interpretative communication SEC (97) 1193 final 20 June 1997

An assessment of the proportionality of a restriction may in fact differ depending on the mode of operation.

Accordingly, a restriction could more readily be considered to be proportionate in the case of an operator working permanently within a territory than in the case of the same operator working only temporarily.

The Court has recognized his difference by imposing a less restrictive and more 'lightweight' legal framework for suppliers of services operating in a temporary capacity than for established suppliers.

It has consistently held that a Member State:

'may not make the provision of services in its territory subject to compliance with all the conditions required for establishment and thereby deprive of all practical effectiveness the provisions of the Treaty whose object is, precisely, to guarantee the freedom to provide services'.

The Court has also held that restrictions on the freedom to provide services are even less acceptable in cases where the service is supplied 'without its being necessary for the person providing it to visit the territory of the Member State where it is provided'

This clarification is particularly relevant to banking services, which are increasingly supplied without physical movement on the part of the supplier.

The Court has likewise consistently held that it does not follow from the third paragraph of Article 60 of the Treaty that:

'all national legislation applicable to nationals of that State and usually applied to the permanent activities of undertakings established therein may be similarly applied in its entirety to the temporary activities of undertakings which are established in other Member States'.

Thus, depending on the circumstances, the same restriction applied in the interest of the general good could be adjudged proportionate in respect of a branch but dispro-

portionate in respect of a temporary provider of services. The Commission considers, for example, that a Member State which imposes certain formalities on credit institutions (controls, registration, costs, communication of information, etc.) for reasons that purport to be in the general good should take account of the mode of operation chosen by the credit institution carrying on activities within its territory under mutual-recognition arrangements.

However, this distinction cannot be applied to consumer-protection rules (provided, of course, that they have satisfied the other tests). The level of consumer protection required must be identical, whether the service is supplied under the freedom to provide services or by way of establishment. It would be unacceptable for a consumer to be less well protected according to whether he received a service from a non-established undertaking or an established undertaking.

It may be necessary, however, to take account of the circumstances in which the service was requested. There may be situations in which the consumer has deliberately avoided the protection afforded him by his national law, particularly where he requests a service from a non-established bank without having first been canvassed in anyway by that bank.

If electronic commerce on the Internet is to realise its full potential, tlie parties doing business must know what rules will be applied to their activities. The principles governing jurisdiction are still under development and in many cases will depend on the laws in force in the country in which the question is raised. In addition, there may be conflicting policy objectives. On the one hand, any rule that requires a retailer engaged in commerce on the Internet to identify and conform to the laws of each country in which consumers may be located would hamper the ability to use

the Internet as a way to expand beyond the local market. On the other hand, consumers should not need to give up the protection of their laws when they venture into Cyberspace, especially if a particular retailer is actively targeting them

Implications of Server Location to Determine Jurisdiction;

The transparent nature and broad reach of the Internet means that any entity desiring to set up a Web site may do so from any one of many physical locations. This decision is made based on a number of considerations such as cost and bandwidth issues.

The very existence of a Web site in a particular jurisdiction may in certain cases constitute the carrying on of business within that jurisdiction. For example, a Web site that supports electronic commerce activities or performs other retailing functions may be programmed to "accept" orders from visitors to the Web site. A court may construe such pre-programmed order-taking activity as the carrying on of business within that jurisdiction.

In many jurisdiction, activities related to investments including trading and related advisory services, are highly regulated. A discussed above, some jurisdictions, including the United States, assume jurisdiction over securities transaction on the basis of united states citizenship. Other jurisdictions, including provincial regulations in Canada, focus their investor protection activities on the basis of residency.

There are a growing number of electronic newsletters and websites on internet related to investments. The supply of such information may result in the providers being characterised as investment advisors and hereby being required to register

under the securities legislation of the jurisdictions where the information is received. Where such activities are regulated and the information provider and the recipient are both residents if the jurisdiction, the provider of the newsletter would likely be required to be registered as an investment advisor. The same result would apply to information that might be construed as a solicitation to purchase a security. Securities regulators may also seek to exercise jurisdiction over a foreign person who sends out electronic newsletters to, or who solicits purchases from, persons who reside in the securities regulator's local jurisdiction. Similar concerns may also apply to information provided on a Web site, although the concerns may be alleviated if the information is not directly targeted to persons residing in the securities regulator's jurisdiction.

The Securities and Investment Board in the United Kingdom has taken the position that the Financial Services Act 1986 could apply to an entity located outside the United Kingdom that runs a Web site which includes an "investment advertisement". This is the case notwithstanding that the advertisement is published, outside the United Kingdom. Two factors to be considered are whether the offer is directed, as a matter of fact, to potential investors in the United Kingdom, and the degree to which technical steps are taken to restrict the material from being accessible by residents of the United Kingdom.

In Canada, the recently retired Chairman of the Ontario Securities Commission, Edward Waitzer, has suggested a new approach to policing the Internet. Specifically, he suggested that regulatory authorities should focus more on transactions rather

than attempt to regulate the information that is posted from their own geographic area.

The inclusion of a disclaimer at the Web site indicating that the contents are not directed to residents of a particular jurisdiction may not be sufficient. In certain cases, the use of a registration process may be necessary to limit access to the site.

B. WETHER WEB SERVER CONSTITUTE A PERMANENT ESTABLISHMENT ?

Under most bilateral Doubles tax treaties, a country will seek to tax corporate business profits if they can be applied to a PE in that country. The basic requirement is therefore, that there must be a place of business and it must have some permanence. The major problem of e-commerce is that no establishment is necessary across the border to carry on business.

With regard to the tangible property, the source can be raced, as the delivery has to cross the other territory through the customs or postal barrier. The destination also will be known from the shipping address. Where the seller is located in a tax-haven country, it becomes difficult to encore tax laws on the non-residents business. In such cases, the natural option would be to tax the resident as the agent, especially where the nonresident cannot be reached.

The problem of taxing those who are assessed and who maintain accounts but in taxing others who do business and there is no record of their transactions, like the persons liable to pay the 'use tax' in US. With the development of Wireless Application Protocol which integrates mobile telephony with the internet, e-

commerce is steadily being taken over by M-commerce. This makes the place of origin of business invisible, thus adding complication to the existing scenario and is a real challenge to domestic jurisprudence. Further, how much income is to be attributed to the permanent establishment is also a significant matter.

Where an automated equipment is operated by an enterprise, a permanent establishment is established; for, it is from that place business is conducted. There is a distinction between hardware and software stored in it. The website cannot be considered a tangible property since a particular location cannot be ascribed to it. But a server has a location and so where it is located permanent establishment is inferred. Individually, cases have to be scrutinized whether business is carried on wholly or partly through the server. While there is no doubt about the inference of the permanent establishment, when the equipment is used wholly for the purpose of business, where it is partly used no such inference is possible unless the use is substantial.

It is not necessary, that personnel should be present at the location of the equipment when work can be done through a local area network.

As already seen preparatory and auxiliary activities do not lead to an inference of a permanent establishment. These are providing communication, .advertisements relaying information for security, collection of internet data and supply of the same. Where, however, an ISP operates its own server to host websites for others, the business is that of the ISP itself and the information) provided to others is not of preparatory or auxiliary character. If it provides information only for advertisement,

permanent establishment is not inferred. But if sales takes place it is permanent establishment.

In general, an Internet Service Provider will not be considered a permanent establishment for other enterprises since they have no power to conclude contracts on behalf of the customers. The observations in the para (supra) that some activities are not of preparatory and auxiliary nature, will lave a bearing on the issue.

That answer seems to be in the negative. Although webservers act as virtual agents representing their respective companies, physical presence of a company abroad would only come within the meaning of permanent establishment. This is a concept well recognised in tax laws of many countries. This scheme works out well in practice. Assume that X Company registered in India approaches a US based ISP for hosting its website. Under the US-India DTAA, the income generated by the Webserver would be deemed to originate in India, since X Company has no permanent establishment as within the meaning of the treaty provisions. The US based ISP would be taxable for the income generated from hiring his Webserver - it would amount to foreign income and the same is taxable since the ISP is incorporated within the jurisdiction of the United States. Similar problems in foreign source income can be analysed with the help of the following table

Type of jurisdiction	Whether Company's foreign income is taxable?

India	Yes, if company either is an Indian company (within the meaning of the Indian Income Tax Act and the Indian Companies Act) or is a foreign company whose control and management is wholly situated in India.28
UK/ Commonwealth	Yes, if company managed and controlled within jurisdiction.
Civil Law countries and the USA	Yes if company incorporated / comiciled within jurisdiction
Territorial basic	No- taxable income arising within the jurisdiction.
Offshore havens	

C. CATEGORISAIOTN OF INCOME

Controversies and Litigation:

Is it a fair & correct legal position where if the income is categorised as business income; it is not taxable; but if it is categorised as royalty or FTS, it is taxable! The source based tax principle (nexus or connecting factor) is based on the presence or absence of source & not upon the category of income! It is so clear that in the current legal position where tax depends upon category, all non-resident assessees

will try to categorise their incomes as business; and tax department will try to categorise it as royalty or FTS.

Can we allow a basic legal position which causes & perpetuates litigation! We may attempt to develop a legal system where tax litigation is reduced rather than increased.

Even if a good structure of - tax treaty & domestic tax law- are evolved, there will still be litigation. Because there will always be some tax payers who simply do not want to pay any tax at all; and there will be some tax officers who would want to tax even a non-resident's foreign incomes. If we ignore these extremes, we can safely say that when like assessees are placed in like tax liability, the incentive to litigate is reduced.

Reasons for Categorisation of Income:

Under the DTA, it is necessary to determine the Country of Source of Income. Since different incomes will have different ways of determining the country of source; different categories are useful to determine the source. The house property income is sourced in the country where the property is situated. The dividend income is sourced (generally) where the company distributing dividend is resident. Salary income is taxable where services are performed. Thus for determining the location or the country of source, the categorisation is useful.

Under the domestic law, computation of income is important. Within a country, different category of income needs different computation provisions. For example,

business income needs detailed provisions for computation. Whereas the salary income computation is simpler. The two kinds of provisions: DTA & Domestic tax law have different reasons for categorisation of income.

Having listed the different categories, no attempt has been made under DTA to prescribe rules for determining the COS, nor the rules for attribution of profits between COS & COR. (As we study Professor Roy Rohatgi's book on International Taxation, we realise that there is a history. There are reasons why the present situation has developed in the manner it has. However, now the changes in the business have reached a threshold. It has become necessary to refine the rules of COI by defining rules of source.

The correct machinery provisions will be - detailed source rules covering every different kind of income. Once the source rules are there, everything falls in place.

Can a **businessman** have his **source of income** in a country where he is neither resident nor does he have a PE? This probability was never considered before the advent of internet. A presumption was made that the income is sourced only in the countries of residence or PE. Hence a rule is made that the business income will be taxed in the country of residence and PE. E-Commerce has challenged the notion that one cannot earn income in foreign country without having a PE in that country.

Where is the rental income from **immovable property** sourced! Very simply the country where the property is located. This is one instance where the category of income and the source of income both give the same results. And hence there are no controversies on this kind of income.

Where is the **royalty income** "Sourced"? This question has not been raised, so no one has answered it. It has been accepted in the model convention that the royalty income should be taxed only in the "Country of Residence". Taxing royalty in the Country of Payment / use is an exception to the OECD convention. Now of course it is followed almost by all countries. Is the "**Country of Payment**" - the "Country of Source"? Not necessarily. Both the terms may indicate the same country or different countries.

Illustrations:

If General Motors manufactures a car in U.S.A. and exports it to Mr. Gerald in Germany, which is the "Country of Source"? The German resident Mr. Gerald makes the payment. He uses the car in Germany. So is the "Country of Payment", the "Country of Source"?

No. The car is made in U.S.A.; the entire "**value addition**" is made in U.S.A. and hence U.S.A. is the "Country of Source".

The "Country of Residence" for General Motors is also the "Country of Source" for the business income. Hence there is no controversy.

Dr. Patel from Mumbai gives medical advice to Mr. Smith in U.S.A. The fees are paid by Mr. Smith's son in Singapore. Country of payment is Singapore. It has nothing to do with Country of Source.

However, when it comes to `Royalty'; so many Governments have simply presumed that the **"Country of Payment"** is the "Country of source". Sometimes, they even argue that the technology for which royalty is being paid; is **used in the** "Country of Payment" and hence the "Country of Payment" has a right to tax it.

The fact that Gerald is using the GM car in Germany does not raise any claims that Germany should tax GM's income. Why should similar situation raise a demand for tax jurisdiction in case of royalty? Since "Country of Payment" is not the "Country of Source", OECD has clearly recommended that the "Country of Payment" should not levy any tax on the royalty payment.

Almost all countries want to levy income-tax on the royalty payments being made from their country. So almost all countries have ignored the OECD recommendation and levied withholding tax on royalty payment. Neutrality between "tangible goods" & "services & intangibles" has been sacrificed.

If we accept that a non-resident's income may be taxed in India only if it is sourced in India; and that just because payment is being made from India, it does not become Indian sourced income; **then royalties** paid to non-residents will not be liable to tax in India. Similarly **Indian software** companies will not be liable to income-tax **in Japan**. (Japan had sought to levy income-tax on Indian software companies even when they did not have PEs in Japan; on the ground that these payments amount to royalties.)

Under the domestic law, different incomes are computed as provided in different provisions of the law. However, having computed incomes from **different sources**

and categories; all the incomes constitute one figure of "**Total Income**". Normal income-tax rate has to be applied to this figure. It is not that different categories of income are taxed at different rates (except where a particular income is to given some incentives). Similarly, when a non-resident's income is to be taxed, all categories of his income should be taxed at the same rate.

Professor Richard Doernberg, in his IFA Report on "E-Commerce and taxation" has raised the issue why categorisation at all? "Income is Income - Distinctions between different types of incomes are artificial". (Page No. 335 in the first edition of the book.) I categorically submit that "Categorisation of Payments" should have no role in sharing of tax rights. Only "Source of Income" and "Residential Status of the Assessee" are relevant.

The OECD TAG on Categorisation of Payments has not discussed the fundamental issue of 'source' of income. It has simply tried to determine in the 28 illustrations given; whether an income might be categorised as 'Royalty' or "Business Income". Once it is royalty, the country of payment acquires jurisdiction to tax the income on 'gross' basis. If it is "Business Income", there is no right to tax.

Because of this position following situation has arisen.

Governments want to categorise all payments to Non-Residents in such a manner that they attract T.D.S. Most convenient is Royalty and FIS. So the definition of these two categories have been made so wide that they can almost cover all payments to non-residents. And non-resident assesses try to categorise all receipts as business receipts without PE. A fundamental cause for controversies and litigation has been built into the system. Removal of this cause can reduce litigation significantly. Categorisation of Income or COI completed.

D. INDIRECT TAXES

The fourth problem arises with incidence and levy of indirect taxes on intangible goods bought and sold via the medium of the Internet. The real problem arises when products having high information value that can be transformed digitally and transferred electronically. India, among other countries taxes only the value of the carrier media and not on the value of the information content, thus bringing down the overall customs rate. The puzzle is of taxing the value of the product also, which is a daunting administrative task for customs authorities. The one easy solution is to let it be, and continue with the policy of taxing the carrier medium only. That would involve applying a "bit-rate" tax for every bit of information downloaded from websites selling intangible products. This can be done by taxing Internet businesses based on their domains, especially the ". com" domain hierarchy, or through IP addresses.[33] The WTO agreement on Customs Valuation has given the members the option to tax the value of the carrier media only, or to include the information value in the customs valuation.

India is yet to take a decision in this regard

The VAT taxes value created in each production step. Transactions are taxable when the product is sold with credits for taxes already paid on inputs. Transaction location is crucial as the selling company collects the VAT and submits the VAT in the country of the transaction. If the seller is in another taxing jurisdiction, the purchaser's government earns no VAT revenue unless the purchaser resells the product. A product used abroad earns no revenue in the seller's jurisdiction as the VAT is rebated to the consumer.

The sales tax only applies to final purchases. Business-to-business (B-to-B) sales are not taxed unless the good is consumed in the business. Transactions are taxable in the jurisdiction where the good is used. The sales tax applies to final purchases within the jurisdiction and the use tax applies to final purchases that are imported into the jurisdiction.

Inter-jurisdictional differences exist in rates and tax base within and between the VAT and sales tax. A standard set of VAT exemptions include postal services, sporting services, cultural services, insurance and financial services, health care, charitable work, education, non-commercial activities non-profit organizations, lotteries, and supply of land and buildings. The standard VAT rate for OECD countries ranges from 5 to 25 percent, with higher rates for luxuries [OECD, 1999], There axe over 7,500 taxing jurisdictions hi the U.S., each with its own set of tax codes. A typical sales tax base exempts services unless specifically taxed and taxes final goods unless specifically exempted. Exempted goods include products for resale, direct inputs into production (both B-to-B), and purchases by non-profits and government. Food, clothing, utilities, and prescription drugs are frequently exempted. State sales tax rates range from a low of 0 to 7 percent.

The dimensions of e-commerce alter the consumption taxes with respect to the characteristics of a good tax: neutrality or efficiency, vertical equity, horizontal equity, revenue potential or stability, simplicity, and administrative feasibility [Stieglitz, 1988].

A neutral tax would not impact the choice of process, the agent, or the type of product purchased. A perfectly neutral consumption tax taxes all final consumption at a uniform rate, leaving relative prices unchanged. Narrow sales tax

bases and varying tax rates make both taxes non-neutral, affecting tax-included price ratios, and encouraging tax-induced consumer adjustments (goods, processes, or agents). Tax code differences across taxing jurisdictions further erode the neutrality and fairness of the taxes.

For neutrality, an ideal consumption tax is applied at the point of consumption so as not to encourage productive capital to migrate to the lowest tax jurisdiction [Hellerstein, 1997]. Differing tax rates or bases can affect the process, agent, or product decisions made by consumers. Process and agent digitization allow on-line search and payment to leave no paper trail for taxing authorities. Non-neutral tax code differences become more difficult to administer in this context and cross-border coordination becomes more important.

The VAT is a source-based tax applied in the taxing jurisdiction where production or sale takes place. The VAT handles cross-border purchases, physical and e-commerce, by rebating the tax to the purchaser (hence not taxing the good in the sending district), and not taxing the good in the receiving district since the seller is not located there. The OECD recognizes this as a loophole in the tax and is working to close it with cooperative international agreements. While the EU has already internalized intra-EU transactions to maintain their taxability, concern remains about non-EU goods having an unfair advantage. The VAT, with a broader base and more uniform tax rates, is at an advantage with regard to tax neutrality issues created by digitizing the process and agent.

Taxes on cross-border purchases are addressed in the U.S. via the use tax. Taxing authority is granted under nexus rules to the jurisdiction where consumption takes place and Constitutional restrictions restrain states from taxing interstate

commerce. If the consumption occurs in a jurisdiction different than the seller, the consumer is responsible for remitting the use tax. The use tax is collected on approximately 5 percent of cross-border business-to-consumer transactions subject to the use tax [GAO, 2000]. The non-enforcement adds to the sales tax's lack of neutrality, a growing problem with increases in e-commerce.

Arguments for special treatment of e-commerce violate neutrality since the process would impact taxability [Cox, 1998]. If a good (for example, software) is digitized and delivered online, neutrality and efficiency would require that the good be taxed at the same rate as its physical counterparts packaged for sale in a retail store. A neutral tax system must treat these options identically to maintain a level playing field between e-commerce and traditional commerce, accounting for the differences in costs of distribution [Hmtz, 1998].

Vertical equity is measured by the extent to which individuals with varying incomes bear different percentages of the tax burden. The VAT and the sales tax can be expected to be regressive since low-income households generally consume a larger portion of their income and thus pay a higher percentage of income in taxes. Based on Eurostat [2001] and Bureau of Labor Statistics [1999] data, the cumulative distribution of consumption expenditures by income class for 13 EU countries and the U.S. indicates that all except Portugal have consumption patterns that are more evenly distributed across income class than in the U.S.. This makes the VAT in EU countries less regressive than the sales tax. The U.S.'s greater income disparity also makes vertical equity more of an issue for the sales tax.

Digitization of any aspect of an electronic transaction impacts vertical equity since high-income consumers are more likely to have Internet access and e-

commerce spending is more unevenly distributed than general spending in the U.S.. This provides higher income households a greater chance to avoid the tax. Based on U.S. Census Bureau *Estate* and *1999 Consumer Expenditure Survey* data, the top income quintile account for 41.9 percent of e-commerce spending compared to 38.0 percent of total consumption spending. The bottom quintile accounts for 7.7 percent of e-commerce spending and 8.6 percent of total spending.

In the U.S., many states have attempted to decrease the regressively of their sales tax by exempting specific items that comprise a large percentage of consumption by the poor. Exemptions apply to all consumers and require correspondingly higher rates on the remainder of consumption, limiting their impact on sales tax progressivity [Derrick and Scott, 1998]. The sales tax base has narrowed from 51 percent of consumer income in 1979 to 42 percent in 2000 [Fox, Luna, and Murray, 2002] in part due to the growth of exempted services.

Exempting e-commerce (or e-products) from consumption taxation would further exacerbate progressivity because the exemption would benefit the rich more than the poor. This is illustrated for the U.S. by the uneven distribution of computer spending, the largest category of e-commerce and the gateway to e-commerce. Approximately 46.4 percent of computer hardware and software related e-commerce purchases are conducted by the top quintile, while the bottom quintile accounts for only 6.4 percent. To the extent that e-commerce is considered a service, the sales tax in most states will not tax it while the VAT will; amplifying the differences in vertical equity problem for these two taxes.

Exemptions are rarely used to address regressively in the VAT. Instead, differential rates are used to address regressively (lower or zero for necessities and

higher for luxuries). The extent to which e-commerce is viewed as a luxury will impact VAT progressivity.

E-commerce penetration, while higher in the U.S. than elsewhere [OECD, 1999, pp. 19 & 34], is expected to increase globally. The administrative challenges of collecting the VAT on e-commerce imports and the use tax's limited enforcement create opportunities for tax avoidance for e-commerce purchasers, affecting vertical equity. The sales tax's exemption of services and the limited exemptions in most VAT taxes make the sales tax less susceptible to new vertical equity problems arising from e-commerce tax avoidance.

Horizontal equity calls for equal tax treatment of purchases for those with similar economic capacity and would be achieved if all purchases were included in the tax base no matter the process, the agent, or what type of product. With the broad number of exemptions, the sales tax undermines horizontal equity since an individual's tax burden is determined by the specific purchases chosen. The VAT's broad base with limited exemptions makes it more horizontally equitable. The equal treatment of e-commerce products with traditional products within the EU community further supports horizontal equity. However, the differing tax rates for necessities and luxuries impede horizontal equity.

While digitization of the process and agent impact vertical equity, digitization of the product has the greatest implications for horizontal equity. If digital goods are electronically distributed, the tax can be avoided in cross-border transactions. In theory, process differences between traditional commerce and e-commerce are inconsequential for the sales and use tax. In practice, difficulties in collecting the use tax lower its horizontal equity. The European Commission has

proposed that digital products that can be downloaded by consumers be subject to the VAT regardless of where they are produced and how they are processed. Proponents hi the U.S. who argue for special treatment of e-commerce hinder horizontal equity, as the process used to make the purchase would impact taxability. While protecting e-commerce, the Internet Tax Non discrimination Act in the U.S. discriminates against non-digital counterparts.

The breadth of the base and the tax rate determine the revenue potential of a consumption tax. Public policy or vertical equity related narrowed tax bases create opportunities for tax avoidance. The rise of services from 12.9 percent of Gross State Product (GSP) in 1977 to 21.1 percent in 1998 has reduced the percentage of GSP that is included hi the sales tax base. Another growing problem is sales to governments, especially in Hawaii and Washington, D. C. [Bureau of Economic Analysis]. Services are not as significant a tax avoidance issue for the VAT since the VAT broadly taxes services.

If e-commerce is generally classified as a service or given a special exemption, sales tax bases relative to total spending will narrow and consumption tax revenue growth will slow. These adjustments enhance existing flaws in the sales tax system. Overall, the EU appears to treat transactions, regardless of the degree of digitization of the product, process, and agent, *in* a more consistent manner. One can argue, therefore, that the VAT's more uniform tax code relative to the sales tax explains why e-commerce has caused less controversy in the EU, particularly with reference to intra-EU transactions.

Digitization of the process and agent facilitates cross-border transactions and creates the opportunity to exploit loopholes hi the global tax structure. Bruce and

Fox [2001] estimated that state and local sales tax losses hi 2001 due to e-commerce were $13.3 billion and will more than triple by 2006. Countries of the EU are concerned with the revenue loss due to e-commerce, especially e-commerce induced imports from non-EU nations such as the U.S.

Digitized products raise another revenue challenge. Digital goods are durable and subject to the Coase conjecture. Low reproduction and distribution costs and the basic non-rival nature of most information suggests that copyright violations lower the demand for legally visible and, hence, taxable transactions. Thus, taxing authorities are very interested in the current intense debate concerning intellectual property rights and the Internet.

Consumption tax revenue is pro-cyclical with the business cycle. The sales tax excludes a number of items important to the poor that are stable across the business cycle. This increases the inherent cyclical behavior of this consumption tax, leading to pro-cyclical boom and bust cycles for state governments. The amplitude of the VAT is expected to be smaller due to its broad base. E-commerce will be more pro-cyclical than general spending since computers and home furnishings account for over 50 percent of spending and tend to be capital expenditures. Non-taxation of e-commerce would decrease the cyclical instability of sales tax revenues [U.S. Census Bureau, 1999 Annual Retail Trade Survey].

To maximize taxpayer compliance and minimize administrative and auditing expense, a consumption tax should be as simple as possible. In the U.S., the large number of exemptions enacted over an extended period has created complex tax codes for the over 7,500 taxing jurisdictions. This complicates the collection of taxes, not only within a jurisdiction, but also exponentially in an interstate or global

context. This complexity issue will decrease in time as computers take over the more detailed cross-jurisdictional transactions. The relative simplicity of a uniform definition of tax base and rates of the VAT, at least within a country, combined with tax coordination within the EU, and the smaller number of jurisdictions, puts the VAT in a better position to address e-commerce growth.

Digitized products inherently entail significant development (fixed) costs but low reproduction (variable) costs make taxation somewhat problematic (especially for a VAT). Different accounting methods can lead to significantly different measures of value added. This is less problematic for the sales tax but the timing of sales tax revenues will be affected.

Digitizing the agent and the process benefits many firms by leveling the playing field against larger firms and expanding market reach. To facilitate this, neither the process, the agent, the product, nor the location should impact the tax. This will require tax code simplification and uniformity in base and rates to achieve administrative feasibility.

Administrative feasibility issues fall into three categories: responsibility for collection, ease of collection, and ease of monitoring. The sales tax and the VAT collection and remission are the legal responsibility of the seller except for inter-jurisdictional direct sales. With a sales tax, the seller is responsible for collecting and remitting the tax if the seller has a presence, nexus, in the consumer's state. If the agent in a cross-border transaction does not meet nexus standards, the agent is not liable for collecting the sales tax from the consumer and payment of the use tax is the legal responsibility of the consumer. Local merchants are at an unfair tax cost disadvantage relative to remote merchants where business-to-consumer transactions

are concerned since the use tax is rarely collected unless the product must be registered, as with an automobile or boat.

Two important law cases define nexus in the U.S. In *Quill v. North Dakota,* 112 ILS. 298 [1992], the court ruled that Quill was not responsible for collecting North Dakota sales tax because its only physical connection with the state is through a common carrier for its products. The court appears to have left open the possibility that this ruling does not apply to all types of interstate commerce and each case should be heard on its own merits [Fox and Murray, 1997]. In *Oklahoma Tax Commission v. Jefferson Lines,* 115 S. Ct. 1331 [1995], the court ruled nexus was established if agreement, payment, and delivery take place hi one state [Fox and Murray, 1997]. This redefinition of nexus - the states' autonomous attempts to solve the inter-jurisdictional commerce problem - may only shift the collection responsibility from the government to the firms engaged in cross-border transactions.

The VAT is always collected from the vendor. The inter-jurisdictional nature of the transaction makes the tax refundable to the external purchaser but places the refund burden on the purchaser. This, inherently, decreases the administrative impact of the inter-jurisdictional transactions. However, inter-jurisdictional transactions by consumers within the jurisdiction are not easy to identify unless the product is resold, in which case the VAT is applied to the total value in the destination jurisdiction. This makes e-commerce a growing loophole to the extent that there are increased direct purchases.

The VAT requires vendors to determine the value added at each stage of production, to file the appropriate tax bills with credits for VAT paid on purchased inputs, and to remit the difference. The sales tax includes similar accounting issues as the tax is applied to all final consumption. B-to-B transactions may be determined as a taxable final consumption or as nontaxable direct production input. Thus, detailed reporting and appropriate remission takes place at each stage of production.

E-commerce raises monitoring concerns related to the traceability of the transactions. When vendors are responsible for collecting the sales tax there will be a paper or electronic trail for auditors to monitor. Not so for inter-jurisdictional transactions *in* the U.S. because out-of-state vendors do not report to the (product's destination) government.

The European Commission fears unfair competition from off-shore businesses and wishes to apply the VAT to all e - commerce. The question is where? If the vendors exist only in cyberspace, they are extremely mobile and able to locate where the tax burden is lowest, highlighting, once again, the issues of equity and neutrality. The traditional application of nexus, based on physical presence, is of little help. Is an Internet Services Provider a common carrier? Is nexus where the company's headquarters are? Where is the vendor in the computer taking the order located—on the server or somewhere in between?

E. E CASH / E MONEY

There is currently no single payment mechanism in use for transactions /conducted through the Internet. The most frequently used method is the Biansmission of credit card information either through an encrypted electronic channel using the Internet, or through an off-line alternative such as through a voice telephone call or a fax

transmission. In the latter case, most of the information concerning the transaction is exchanged on-line, and the information provided off-line to effect payment must be matched to the on-line transaction.

In the above-mentioned payment mechanisms, the credit card information is sent to the merchant for processing like a mail order or phone order transaction. An alternative model for electronic payment is for the bank or credit card organisation to participate in the transaction in a manner that precludes the need for providing the credit card number to the merchant. Instead, the information is transmitted. either directly or by means of an encrypted envelope sent via the merchant's system to the bank or credit card company which then issues a confirmation code to the merchant.

Electronic Money

Several mechanisms for implementing electronic money have been conceived. Although electronic money systems can provide a cost-effective mechanism for micro transactions or small denomination purchases on the Internet, they are still in the relatively early stages of development. Issues that must be addressed to ensure future growth include interoperability, privacy, authentication, and verification. While many of these issues will be solved, the growth of electronic money systems may still be slower than expected by some proponents.

Electronic money is based on public key encryption technology that creates a block of digital data that can represent money and be used for payment. In general, there

are two distinct forms of electronic money: identified electronic money and anonymous electronic money. Identified electronic money contains information that can reveal the identity of the person who was issued the money from the bank. Some forms of identified electronic money also allow the issuing bank to track the electronic money as it moves from one person to another. In contrast, anonymous electronic money cannot be tracked by the issuing bank and can be spent or transferred without leaving a transaction trail.

Some electronic money schemes permit person-to-person transfer, like real cash, while others require that a consumer transfer the money directly to a merchant as payment for an on-line transaction. Some electronic money schemes also require access to an on-line network connection when the money is transferred, while others permit transactions to occur off-line without the involvement of the bank. The most complex form of electronic money is anonymous electronic money that can be transferred off-line because some sort of mechanism is required to prevent double-spending.[104]

With some forms of electronic money, specifically a tokenised system where the real electronic money is transmitted electronically, a loss of the digital representation of the money can result in a real loss to the owner. With other systems, the electronic money is simply a notational system or record rather than the money itself. In the

[104] Anonymous money can be structured to accumulate information as it travels from peso to person. The system can be structured so that the transaction trail will only be revealed if the electronic money is spent on more than one occasion. If the money is not double-spent then the bank will not have sufficient information to determine the identity of the original spender or reconstruct the path taken as the electronic money moves from one person to another.

latter case, the money can be returned to the consumer on the bank being notified of its loss or destruction.

Trade in drugs and the takings of profits from organised crime as well as other types of criminal activities generate money that must be integrated into the financial systems for criminals to make use of the money. Law enforcement agencies have historically relied on the intermediation of banks and other financial institutions to provide choke points through which funds must pass. Therefore, a major concern regarding the use of electronic money, especially anonymous electronic money, is the potential that it will be utilised for money laundering purposes. However, some of the anonymous electronic money schemes allow at least one of the parties to be identified so that the resulting tender does not become a useful tool for criminals. w Security for Electronic Commerce.

Chapter - 6

THE CURRENT DEBATE: THE RESPONSES TO THE CHALLENGES

The current debate about international taxation of e-commerce focuses mainly on feasibility challenges. The challenges are debated solely from a tax law perspective, using technical tax law arguments. This debate has suggested several responses to deal with e-commerce taxation challenges. Currently, there are four main suggestions: (1) that the international regime clarify income-classification rules and consider servers as permanent establishments;[105] (2) that the regime apply a one-source rule, demand jurisdiction, to all e-commerce income;[106] (3) that the regime apply formula taxation;[107] and (4) that the regime exclusively apply residence based taxation (personal jurisdiction) to e-commerce.[108] I will now briefly discuss these responses and argue that they fail to present a deep and interesting discussion of e-commerce taxation that might lead to appropriate taxation.[109] I emphasize that one of the reasons behind this failure is the lack of consideration of cyberspace law literature, arguments, insights, and experience.

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[105] OECD, *supra* note 3

[106] Avi-Yonah, *supra* note 4

[107] Li, *supra* note 5.

[108] OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, *supra* note 6.

[109] For additional responses, see DOERNBERG ET AL., *supra 2* (tax-base-erosion approach); PINTO, *supra* note 2; Nicolas DeBoynes, *International Tax Policy and the New Economy, 2* GLOBAL JURIST FRONTIERS (2002) (virtual permanent establishment); Richard Doemberg, *Electronic Commerce: Changing Tax Treaty Principles a Bit?,* TAX NOTES INT'L, 2417 (2000); Richard Doernberg, *Electronic Commerce and International Tax Sharing,* TAX NOTES INT'L, 1016 (1998); Luc Hinnekens, *Looking for an Appropriate Jurisdictional. Framework for Source-State Taxation of International Electronic Commerce in the Twenty-First Century,* 26 INTERTAX 192 (1998) (virtual permanent establishment); Diane Ring, *Exploring the Challenges of Electronic Commerce Taxation Through the Experience of Financial Instruments,* 51 TAX L. REV. 663, 666 (1996); Arthur Cordell, Taxing the Internet: The Proposal for a Bit Tax, Address to the International Tax Program at Harvard Law Schdol (Feb. 14, 1997) *available at* http://arraydev.com/commerce/jibc/9702-05.htm.

A. Clarifying Income-Classification Rules and Considering Servers as Permanent Establishments

The OECD plays a central role in the field of e-commerce taxation.[110] OECD responses to e-commerce taxation challenges are much more developed than national responses. It has even been argued that the OECD role is replacing a national role.[111] The OECD started the discussion on e-commerce taxation in 1997 during the Turku Conference. In 1998, the Ottawa Taxation Framework was designed and approved. The leading principle of this framework is as follows:

The taxation principles that guide governments in relation to conventional commerce should also guide them in relation to e-commerce.... Existing taxation rules can implement these principles. The application of these principles to e-commerce should be structured to maintain the fiscal sovereignty of countries, to achieve fair sharing of the tax base from e-commerce between countries and to avoid double and unintentional non-taxation.[112]

Following Ottawa, five Technical Advisory Groups (TAGs) continued the research and dialogue. Their work resulted in several reports on different issues of e-commerce taxation challenges. These reports suggested explanations and clarifications to several principles and concepts of the current international tax regime. The primary challenge the TAGs addressed were income classification and permanent establishment. As to income-classification issues, a set of clarifying

[110] *See* OECD, *supra* note 3.

[111] Arthur Cockfield, *The Rise of the OECD as Informal "World Tax Organization " Through the Shaping of National Responses to E-Commerce Challenges*, 8 YALE J.L. & TECH. 136 (2006).

[112] OECD, *supra* note 3.

examples and rules was added to the OECD Model Tax Treaty. This set included a large number of technically detailed examples of transactions and the classification of each one. As to the permanent establishment principle, it was added to Article 5 of the OECD Model Tax Treaty, which stated that a server might constitute permanent establishment as long as it was "an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment.[113]

I argue that the OECD view is limited because it ignores cyberspace law perspectives and misses central, important insights that can be brought by wider perspective and open-minded thinking. The OECD discussion exclusively focused on tax issues and did not pay any attention to cyberspace law literature that dealt with difficulties of regulating the Internet and applying the current law to Internet activity. The OECD discussion also lacked real attention to the normative challenges and acceptability challenges of e-commerce, concentrating only on the feasibility challenges. For all these reasons, the OECD approach is difficult from an analytical point of view and cannot produce satisfying outcomes to appropriately tax cross-border e-commerce income.

The OECD approach is still based on the territorial location of the server, a highly irrelevant and mobile factor and one that cannot lead to well-established taxation of e-commerce income. The specific OECD proposals to the feasibility challenges are not likely to lead to successful taxation of international e-commerce income. The clarifications to income-classification rules are arguably so sophisticated that they

[113] OECD, CLARIFICATION ON THE APPLICATION OF THE PERMANENT ESTABLISHMENT DEFINITION IN E-COMMERCE: CHANGES TO THE COMMENTARY ON THE MODEL TAX CONVENTION ON ARTICLE 5, art. 48.2 (Dec. 22, 2000), *available at* http://www.oecd.org/dataoecd/46/32/1923380.pdf.

cannot even be used as a helpful tool in the process of classification. The large number of examples given with many technical and specific details cannot be used as a guiding and useful working tool for tax authorities or for the international business community.

As for the rule of the server as a permanent establishment, it is still a rule that relies on physical location, with all the difficulties of applying rules based on physical locations to the Internet. It is difficult to make a connection between an e-commerce transaction and a server in one place or another. It is also easy to deliberately locate the server in any low-tax jurisdiction or tax haven. Furthermore, there is no justification for giving sole jurisdiction to tax the income to the country of the server, because often there is no real economic allegiance between the place of the server and the production of the income. Finally, reliance on the location of the server will open the door to tax manipulation.[114] The ten years' experience since the rule was accepted shows that it does not actually generate taxation of international e-commerce income. The OECD itself is gradually reaching the same conclusion.[115]

B. Applying a One-Source Rule for All E-Commerce Income: Demand Jurisdiction

Professor Reuven Avi-Yonah articulated one of the first responses to the challenges of e-commerce taxation.[116] He considered the main challenges and made several proposals, though it is important to note that he, too, did not give any attention to cyberspace law literature and arguments; instead, he focused entirely on tax. First,

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[114] *See* Arthur Cockfield, *Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation,* 85 MINN. L. REV. 1171, 1194 (2001); Cockfield, *supra* note 18, at 608; DOERNBERG ET AL, *supra* note 2, at 184; Li, *supra* note 5, at 459.

[115] See Cockfield, Transforming the Internet, supra note 39, at 1197

[116] Avi-Yonah, *supra* note 4.

he suggested "sidestep[ping] the classification issue by subjecting services, royalties, rents, and sales in electronic commerce to the same source rule.[117] Second, he argued that a nonphysical threshold is required to tax e-commerce income.[118] Therefore, he suggested that "a gross withholding tax is imposed on sales (and services) provided through electronic means into the Demand Jurisdiction, at a rate equal to the corporate tax rate in the Demand Jurisdiction.[119]

Professor Stanley Katz criticized these proposals.[120] He argued that the suggested gross withholding tax leads to over taxation or double taxation in some circumstances. In my opinion, the first proposal to apply one-source rule for all categories of income is feasible but problematic from a neutrality point of view because it makes two separate international tax regimes: one for e-commerce and one for non-e-commerce. Furthermore, there is a serious difficulty in a proposal that gives sole authority to tax e-commerce income to the demand jurisdiction. The demand jurisdiction contributed its markets to the production of the income, but there is no reason to abandon the right of taxation of the other jurisdictions. The sharing of the tax pie according to this proposal does not meet the normative criterion of intimation equity.

[117] Mat 545.
[118] *Id.* at 535.
[119] Mat 537.

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C. Formula Taxation

Professor Jiyan Li examined the international tax regime in the age of e-commerce.[121] She argued that e-commerce exposes and exacerbates the rooted difficulties of the regime in the globalization era.[122] To manage these difficulties, she proposed making a distinction between portfolio income and direct business income.[123] As to portfolio income, she proposed a uniform withholding tax by the payer's country of residency. As to direct business income, she proposed to split the jurisdiction to tax the income among the different countries involved in the transaction according to a formula that takes into account all the relevant economic-allegiance factors.

This proposal ignores the basic features of e-commerce as global, virtual, and anonymous commerce. It tries to locate the places of e-commerce and the contribution of each place to the production of the income. But all the current challenges of e-commerce stem from the basic fact that there is no *place* for e-commerce except the Internet, as a place of its own. Hence, the proposal generates the same challenges that face the current international tax regime. The global character of e-commerce makes it difficult to determine the relevant countries to plug into the formula. The same is true of the virtual nature of e-commerce. The anonymity of e-commerce makes it even more difficult to apply the formula.

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[121] Li, *Supra* Note 19.

[122] *Id at* 494.

[123] *Id. at* 590.

D. Exclusive Residence-Based Taxation (Personal Jurisdiction)

One of the first responses to e-commerce taxation challenges was made in 1996 by the U.S. Department of the Treasury.[124] The Treasury argued that

> [t]he growth of new communications technologies and electronic commerce will likely require that principles of residence based taxation assume even greater importance. In the world of cyberspace, it is often difficult, if not impossible, to apply traditional concepts to link an item of income with a specific geographical location. Therefore, source based taxation could lose its rationale and be rendered obsolete by electronic commerce. By contrast, almost all taxpayers are resident somewhere.[125]

This and other similar proposals might deal well with the feasibility challenges of e-commerce because they totally ignore territorial taxation and focus on personal taxation.[126] But personal taxation cannot be applied to e-commerce, because it is difficult to determine e-commerce corporation residency. In addition, as mentioned above, it is easy to escape such taxation because e-commerce is anonymous, and in any case, e-commerce corporations can easily receive residency in a low-tax or zero-tax country. But the main difficulty with the Treasury proposal lies in its normative basis. It gives advantages and benefits to resident countries, which tend to be developed countries, over source countries, which tend to be developing countries.[127] It infringes inter-individual equity and economic efficiency because it

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[124] OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, *supra* note 6.

[125] Mat 23.

[126] The Lejeune et al., *Does Cyber-Commerce Necessitate a Revision of International Tax Concepts?*, 38 EUR. TAX'N 50 (1998); Sweet, *supra* note 19; Thorpe, *supra* note 20

[127] Cockfield, *supra* note 22; David Forst, *Old and New Issues in the Taxation of Electronic Commerce*, 14 BERKELEY TECH. LJ. 711 (1999).

distinguishes between the tax regime on e-commerce and the tax regime on non-e-commerce transactions. It would be very difficult to gain international consensus for such a proposal, as evidenced by the ten years that has passed since the proposal was first made, without its adoption.

The OECD proposal is the current leading proposal being applied on the positive level, but it does not produce satisfying taxation of e-commerce income. Reasons for the failure include the limited perspective of the debate and its technical approach. I will show that the debate is missing a basic point that if filled, will enrich the debate and lead to better solutions. I will start filling this gap in the next part, in which I aim to usher in a new era of debating e-commerce taxation and designing successful tax models for e-commerce income.

Chapter - VII

THE INTERNATIONAL TAX REGIME

Efforts to build a rudimentary international regime in the area of taxation gained momentum in the years immediately following World War I, driven primarily by concerns about "double taxation," or the possibility that different countries would attempt to tax the same cross-border transactions or income. In 1921 the League of Nations commissioned four experts in public finance to study the economic consequences of double taxation. After the experts concluded that double taxation interfered with "economic intercourse and... the free flow of capital" and prevented an "equitable distribution of burdens" among taxpayers (quoted in Mann, 1997), the League drafted several "model treaties" on double taxation, which provided templates for bilateral treaties that countries could negotiate in order to clarify their respective rights in the taxation cross-border transactions and income. After World War II, the OECD continued the League's work and eventually published its own Model Income Tax Convention in 1963[128], which today remains the cornerstone of the international tax regime: most of the 1,500 or so bilateral tax treaties in the world are "substantially similar" and are based on the principles set out in the Convention (Forst, 1997).

The Model Income Tax Convention attempts to reconcile two competing approaches to taxing income. The first approach - the "residence principle" - holds that countries have a right to tax the income of people or commercial entities that

[128] Articles of the OECD Model Tax Convention on Income and on Capital," April 29, 2000, reproduced on the OECD website: http://www.oecd.org/daf7fa/treaties/MTCArticles.pdf.

reside within their borders. The second approach to income taxation - the "source principle" - holds that countries can tax income that arises from sources in that state, regardless of whether the parties involved in the transaction are residents in that state. Most countries employ both approaches to taxation simultaneously: they tax the income of resident individuals and companies, and they tax income generated within their territory. This practice, however, raises the possibility of double taxation, since income generated by nonresidents could conceivably be taxed both by the country from which the income derives (the source jurisdiction) and by the income-generator's home country (the residence jurisdiction).

To avoid double taxation, the OECD Convention offers the following formula: Countries can tax income based on both source and residence, but they should also compensate their own residents - through tax deductions or credits - for income I taxes paid to foreign governments. In addition, the Convention sets out criteria to determine residency (individuals are deemed to reside in the country in which they I have the strongest "personal and economic links"), establishes guidelines for the taxation of nonresident businesses (whose income may be taxed as long as it derives from a "permanent establishment" - defined as any fixed place of business, such as I a branch, office, or factory - maintained in the taxing country), and clarifies the 1 differences between various types of income.[129] Together, the OECD Convention and the network of bilateral tax treaties, which are based largely on the Convention, make up the core of the current international tax regime. Four features of this regime stand out. First, it presupposes a clear link between geography and

[129] The definition of "permanent establishment" excludes facilities that are solely maintained for the "storage, display or delivery of goods or merchandise."

commerce: allocating taxation rights under the current regime involves locating the geographical source of income, or the residency status of those engaged in income-producing activities, or both. (It should be noted that the OECD Convention thus did not invent the linkage between territory and tax, but simply reaffirmed the long-standing territorial and state-based character of taxation.) Second, it is a "weak" regime: there is no requirement that states implement the OECD guidelines, no enforcement or monitoring of state behavior, no international mechanism to resolve international disputes, and no centralized system for sharing information that states could use to coordinate their taxing efforts if they chose to do so. Third, it is a "narrow" regime: the guidelines focus almost exclusively on direct (or income) taxes, and largely ignore indirect, or consumption taxes (for example, sales tax or value-added tax), which in fact represent an increasing share of national tax revenues among the members of the OECD. Fourth, it is primarily a bilateral, not multilateral, regime: although the Convention was negotiated multilaterally among OECD members, implementation of the Convention involves the negotiation of bilateral treaties between pairs of states - unlike, for example, the multilateral mechanism that governs international trade. In short, the international tax regime is geographical in conception, limited in scope, and decentralized and voluntary in application. These characteristics have led some commentators to claim that it should not be considered a regime at all (Rosenbloom, 2000). This position, however, is rejected by most tax experts, who argue that the ubiquity of bilateral tax treaties based on the OECD Convention highlights the existence of a common set of principles, norms, rules, and decision-making procedures around which actors' expectations have converged in the area of taxation.[130] Yet in spite of this

[130] In other words, international tax arrangements do meet the most commonly accepted definiuon of an

uniformity, the regime does not impinge very much on the autonomy of states to design and manage their own taxation policies: it is, fundamentally, a minimalist set of arrangements designed to reduce double taxation on cross-border income.

Recently, members of the OECD have expressed concern that the existing tax regime may be inadequate to cope with taxation problems arising from the "accelerating process of globalization of trade and investment" (OECD, 1998b: para. 21). In particular, the diminishing costs of transportation and communication are making it easier for corporations and individuals to shelter investments and income in offshore tax havens, and raising fears of a possible "race to the bottom" in which all jurisdictions might drastically reduce taxes in order to attract investment, thus eroding the global tax base. In 1996, OECD ministers and the Group of Seven industrialized nations issued separate communiques condemning "harmful tax competition" and calling on the OECD to "vigorously pursue its work...aimed at establishing a multilateral approach under which countries could operate individually and collectively to limit the extent of these practices" (quoted in OECD, 1998b: para. 2). Two years later, the OECD unveiled a plan aimed at combating tax competition, the main elements of which included evaluating countries' tax policies for evidence of "harmful tax measures," publishing a blacklist of tax havens that refuse to implement reforms, identifying punitive measures that countries could take against these tax havens, and creating a forum within the

international "regime." See Krasner, 1982; Avi-Yonah, 2000a.

OECD to serve as an information clearinghouse and coordinator of national measures against tax havens.[131]

It remains to be seen what will come of these plans, but current proposals would involve a significant broadening of the international tax regime beyond its long standing focus on double taxation, and into the realm of appropriate national tax *rates,* along with a new emphasis on multilateral action to uphold the international tax regime. In addition, as we shall see below, the OECD has conducted extensive consultations with member states, business groups, and other international organizations on the particular challenges that the rise of electronic commerce pose to the existing international tax regime,[132] and in March 2002 announced the creation of a new "International Dialogue on Taxation" to serve as a central communications hub for national governments and international agencies on issues of tax policy and tax administration, including the effects of economic globalization on existing tax practices (OECD, 2002).

There are good reasons to believe that, the rise of global electronic commerce will spur a substantial broadening and strengthening of the international tax regime. This is not to say that states will cease to collect taxes themselves, or that a supranational taxing authority will be created, but rather, that the rise of e-commerce is likely to precipitate a shift in the relative balance of de facto taxing authority from the domestic to the international level as states come to realize that technological changes in the nature of commerce require higher levels of

[131] OECD, 2000. For an analysis of this initiative see Samuels and Kolb, 2001

[132] For a comprehensive review of the OECD's activities in this area see OECD, 2001.

international tax policy coordination. This conclusion rests on several premises: (1) that international e-commerce will continue to grow; (2) that the spread of this commerce will challenge existing systems of taxation; (3) that national governments will ultimately demand the taxation of digital commerce; and (4) that the effective taxation of electronic commerce will require extensive international coordination. I defend each of these premises below.

CHAPTER - VIII

CONCLUSION

In its latest progress report[133] on the implementation of the Framework Conditions, the OECD's Committee on Fiscal Affairs confirms that the most frequently quoted principle during its analysis has been that of the neutrality of taxation between electronic commerce and conventional commerce. However, it has also noted that this principle may be breached if the taxation of e-commerce continues to be studied in isolation to international tax issues impacting conventional commerce.

The OECD's Consumption Tax Technical Advisory Group ("TAG") released a report[134] in 2003 on e-commerce implementation issues which considered two further issues high on the political agenda: the potential for double taxation or non-taxation as a result of conflicting place of supply rules, conflicting definitions, conflicting tax results arising from differences in verification requirements between jurisdictions, and incompatible approaches to "bundling" issues, i.e. where an e-commerce supply involves a number of different elements.

That report identified different approaches which have been taken by countries to the taxation of cross-border services and intangibles in national tax systems. The emerging international view is that such differences have increased the potential for double taxation and unintentional non-taxation, not Just fore "commerce but in the broader context of international trade in services and intangibles' where consistency between countries is increasingly essential. Consequently, focusing one - commerce

[133] "Implementation of the Ottawa Taxation Framework Conditions", the 2003 Report, which is available for review at: *http://www.oecd.org/dataoecd/45/19/20499630.pdf.*

[134] The 2003 report is entitled "Implementation Issues for Taxation of Electronic Commerce". See: *http://www.oecd.org/dataoecd/38/42/5594899.pdf.*

issues as a separate category of services alone may mean that issues affecting other internationally traded services will be missed orJead to further international conflicts.

The OECD, through its Committee on Fiscal Affairs, is therefore adopting a more "holistic" approach to taxation, rather than on specific aspects such as e-commerce. This is not to say that the Framework Conditions are no longer relevant—although they were designed in the context of e-commerce, the international view is that they will remain valid as they broadly reflect the philosophies and policy goals of existing tax rules in most countries. However, the Framework Conditions and related work on E-commerce, are now being incorporated into the Committee's mainstream on international commerce issues.

This is illustrated by the Committee's latest project on the application of consumption taxes to international trade in services and intangibles, for which further tax principles and remedies are being developed, and is also consistent with the approach being taken by the Commission to amend the EU VAT place of supply rules on a wider basis arid not just affecting internet traders.

Therefore, it would now seem that any further policy work specifically on e-commerce is only likely to arise as a result of the EU and the OECD's monitoring of e-commerce developments and new technologies, where these may significantly challenge the international consensus reflected in the work achieved to date, and which may necessarily require refinements to treaty rules or new taxes to be introduced.

Electronic commerce represents a qualitatively new form of commerce that defies many of the assumptions upon which existing national tax systems and the

international tax regime are based, including the notion that transactions can be located in physical space. As a result, there is a growing disjuncture between the international tax regime and the nonterritorial character of digital commerce. Jean-Marie Guehenno captures the essence of this problem: "When there is no longer a territorial imperative, when the place of residence and the investment are no longer a given but a choice, when added value is generated in too abstract a fashion for its creation to be assigned a precise location, taxation is no longer a sovereign decision" (Guehenno, 1995:10). Guehenno errs, however, in asserting that taxation cannot remain a "sovereign" decision. If one accepts that *effective* sovereignty, or what &3fBg£ called de facto political authority, can be and is being disaggregated and internationalized, then sovereignty over taxation could conceivably shift from territorial states to a decentralized "international state." Indeed, this process appears already to be under way, and there are strong indications that it will accelerate in the years to come.

According to folklore, Michael Faraday, who discovered the principle of electromagnetic induction, was asked by a British politician what use electricity might have. Faraday replied, "I do not know what it is good for. But of one thing I am quite certain— someday you will tax it." This quotation is, most probably a myth, but even so there is significant truth therein. Like electricity, that was eventually taxed, the e-commerce can and will be taxed - the important thing is that it be taxed fairly and efficiently (just like conventional commerce). There's no doubt that governments will e their tax revenues to evaporate. The truth is, governments are supposed to provide their citizens with services such as schools, hospitals, transport infrastructure, social security provisions, etc. and in practice taxation still holds a major role in securing the funds for those services exist. So we can think of

taxation of e-commerce as a normal part of the way of how governments operate. What should be encouraged is for tax authorities internationally to make the most of the technology and infrastructure of Internet to improve, and to resolve to a common ground on e-eommerce taxation. EU has taken some steps which seem rather promising, but it will require international consensus for such a big challenge to be met and resolved in an efficient manner.

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