

# Chapter 3

## Direct Taxation and E-Commerce: Possibility and Desirability

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### ABSTRACT

*E-commerce poses significant challenges for existing tax rules. One of the most important effects of e-commerce has been to de-emphasise the significance of the place where economic activity is carried out, which makes it difficult to determine which jurisdiction has the right to tax. It has also blurred the traditional distinction between the form of delivery and the substance of what is delivered. Thus, the specific tax implications of e-commerce and the threat it imposes on the established tax systems can be examined by reference to how much e-commerce tends to disrupt the concepts and principles of direct taxation and international tax treaty rules. This article explores the effect of e-commerce on the principles of direct taxation. The question is should the tax system of the future be developed at a national or an international level?*

### 1. INTRODUCTION

Even before the advent of e-commerce it was not always easy to determine where income arose. Countries consistently differed over whether the presences of a facility, the location of customers,

the passage of title or a number of other factors determine where the income arises (Doernberg, 1999). This article explores the effect of e-commerce on the principles of direct taxation. It presents different proposals and options for reforming the direct taxation of e-commerce. In so doing, it analyses the different approaches and policies towards taxation of e-commerce. It

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is argued that the present international taxation<sup>1</sup> is one of the most important but least studied topics in all of tax; indeed, it may be one of the most undeservedly ignored topics in all of law.<sup>2</sup> One of the reasons the topic is so important in the real world and yet so little loved of scholars is that international tax law is both excruciatingly complex and fundamentally arbitrary.<sup>3</sup> One of the principal reasons for this irrationality is simple: there is as of yet no consensus as to how the tax base represented by the world economy should be shared among the world's roughly 200 nations (Li, Cockfield and Wilkie 2006 pp 375-377). Currently, for the most part, each government decides unilaterally what portion of that base to claim. As a result, some parts of the world economy are taxed once, some twice, some many times, and some not at all. Much of the theory on international taxation that has been developed over the years to address the above issues presupposes that there are, broadly speaking, no undue difficulties in identifying the economic activities from which the taxable income is derived, ascertaining the location where such activities are carried out, and verifying the primary residence of the parties to which the income accrues. This presupposition, which forms the basis on which the boundaries of most national tax jurisdictions have traditionally been drawn, has become much less tenable today with the ever-increasing dominance in international commerce, lately by e-commerce exerted by multinationals with highly integrated operations, and the ease and speed with which financial capital can move from country to country (Zee, 1998). While business is already truly global, the world's tax regimes are still largely parochial and uncoordinated. As a result, tax considerations routinely drive the structuring of international businesses and transactions (Basu, 2007).

In spite of the magnitude and complexities of international trade and commerce, and in spite of the diversities of domestic income tax regimes, the tax rules that apply to international transactions are surprisingly similar in most countries.

Furthermore, they rest upon the use of a relatively small number of concepts: (1) the choice of specific principles (e.g., residence and source-based taxation) for governing the tax treatments of both domestic source income accruing to non-residents and foreign-source income accruing to residents; (2) the use of the concept of permanent establishment in establishing the economic nexus required to assert jurisdiction to tax business profits; (3) the economic effects of these principles (e.g., their impacts on the worldwide allocation of investments and savings); (4) the application of alternative methods (e.g., tax credits or exemptions) for effecting (juridical) double-taxation relief; (5) the formulation of appropriate provisions (e.g., inter-company transfer pricing rules for multinationals) for the effective implementation of the chosen tax regime; and, finally, (6) the negotiation of bilateral (and sometimes multilateral) tax treaties to alleviate the undesirable effects of non harmonized tax policies among countries.<sup>4</sup> The question is does taxation of e-commerce require a fundamental change in existing tax rules? This article, then, is intended to illustrate the need for reassessment of some of the principles of international direct taxation, it not only identifies a continued central and legitimate role for sovereign states to determine tax policies but it also proposes that in order to bring e-commerce within the scope of prevailing tax rules and norms, tax authorities have to invoke inadequate definitions and inappropriate analogies.

It is nothing short of a miracle considering the high degree of rigidity and political willingness to opt-out that a consensus emerged among developed countries in the post-war period about the use of these concepts in guiding the allocation of worldwide income among the Organisation for Economic Co-operation and Development (OECD) countries. However it can also be argued that this apparent OECD consensus was really a Washington consensus and that the concepts largely served the self-interest of large capital-exporting countries. But whatever the political

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