The Challenge of the Internet & E-Commerce to the Efficacy of National Tax Regimes

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INTRODUCTION.

Internet Commerce not only presents a significant challenge to the efficacy of national tax regimes, but it may also be deemed a fundamental road block to taxing officials in their quest to impose as well as collect income from the various taxing sources. The efficacy of any tax regime is its ability to levy taxes on its citizens and business corporations in order to further public policies i.e. tax collection is the vehicle through which national governments raise revenue for the peace, order and good government of their countries.[1]
The premise on which government can legally impose tax on its citizens and business corporations are based on established principles of Taxation e.g. the common law principles of jurisdiction based on residence, non-residence, permanent establishment, physical presence, nationality...

Electronic Commerce (hereinafter referred to as e-commerce) however, have ushered into existence a new way of doing business which not only seeks to reduce cost, but have, to a large extent undermined the whole premise on which tax regimes have been established. The certainty with which tax is usually collected i.e. residence, permanent establishment etc. is fast becoming a thing of the past.
The question to ponder then is, what is e- commerce and how has it impacted on the taxing jurisdiction?

E-Commerce is defined as "any transaction conducted over the Internet or through Internet access comprising the sale, lease, licence, offer or delivery of property, goods, services or information whether or not for consideration and includes the provision of Internet access.[2] E-Commerce is also held to be the conducting of commercial activities through electronic means...the ex-

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1 The Jamaica Constitution (Order in Council) 1962.

2 *Internet Tax Reform Act.* British Tax Review 2000.

change of goods or services using electronic tools and techniques.[3] E-Commerce is an all-encompassing form of commercial transaction that is based on electronic processing and transmission of data. It is a medium through which businesses are operated, physicians treat patients.... "This type of service center takes place between businesses, within a business, between business and consumers and between business and governments".[4]

The Internet as expressed in the form of e-commerce "recognizes no national boundaries and it is capable of transmitting information instantly all over the world. It is not subject to much regulatory control i.e. in relation to the parties, their conduct, location, records and audit of commercial transactions. This is based on the fact that the Internet has no central control. A web-site does not always point to its owner(s) location. The implication for taxing jurisdictions then is that based on the nature of the e-commerce business enterprises, national governments will have difficulties in tracking business transactions for the purpose of collecting taxes simply because of the lack of adequate information, the uncertainty of identifying where the business is taking place and who the end receivers actually are.

Throughout the Caribbean and the world at large, tax officials had traditionally based their authority to tax their citizens on certain criteria (as was mentioned earlier) such as residence, jurisdiction, source to name a few. However, E-Commerce and its "cyberspace" characteristics i.e. its ability to disguise its business operations, have largely undermined this authority. This is evident in relation to a Government's jurisdiction to tax[5].

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3 See U.S. Report of the Treasury. Selected Tax Policy Duplication of Global Electronic Commerce (Washington D.C.: U.S. Government Printing Office. Nov. 1996. Canada, Electronic Commerce and Canada's Tax Administration: A report to the Minister's Advisory Committee on electronic commerce (Ottawa: Revenue, Canada April 1998) 1.2 defines electronic commerce as the delivery of information, products, services or payments by telephone, computer or other automated media.

4 Kalakata and Whinston, *Frontiers of Electronic Commerce* 411.

5 As was noted in the 1999 Conference Report. Report of proceedings of the 51st Tax Conference. Canadian Tax Foundation at The Montreal Convention Centre. Sept. 26-29, 1999. The internet increasingly strips away the physical limitations of doing business internationally.

JURISDICTION AND E-COMMERCE

A government's authority to tax has always been premised on territory and jurisdiction e.g. the Caribbean governments tax their residents on their worldwide income because they are connected with the jurisdiction through "citizenship and residence"[6]. Jurisdiction confers automatic authority on taxing officials to allocate tax liability on persons physically present in the forum however brief, ***Worldwide Volkswagen v Woodsen***[7]. In that case the Supreme Court noted that the purposeful availment requires the defendant's conduct and connection with the forum to be such that he shall reasonably anticipate being haled into court there.

JURISDICTION BASED ON PHYSICAL PRESENCE

Physical presence is an integral tool for enforcing tax liabilities. This is evident in the case of ***Re Young***[8]. This case involved a seaman who spent very little time in England because of the nature of his job. The courts however found that he was present in England and therefore assessable to the revenue office because of his mode of life and his connection with that jurisdiction.

In ***Levene v IRC***[9] Viscount Care held residence to mean:

1. To dwell permanently for a considerable time
2. To have one's settled or usual abode

He went on to note that once a man's settled or usual abode was determined, he was no less a resident because from time he leaves it for the purpose of

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6 Zippo Management Co. Ltd. V Zippo.Com Inc. 952F. Supp 119 (W.D. Pa) 1997. In Zippo the court concluded that the exercise of personal jurisdiction in internet cases fell into three categories. On the one end of the spectrum were instances where a defendant posted information that could merely be accessed on the internet, where a defendant would not ordinarily be subject to personal jurisdiction in a foreign as a result of the plaintiff accessing the web-site from such jurisdiction. At the other end of the spectrum and where the defendant could expect to be subject to personal jurisdiction in a foreign jurisdiction would be certain interactive web-sites.

7 465 U.S. 770 1984. http://caselaw.1p.findlaw.com.scripts/getcase.

8 [875]1.T.C.

9 [1928] A.C. 217

business or pleasure. On this basis therefore, physical presence for tax purposes can be attributed to the individual whose commercial activities takes him outside his jurisdiction. Physical presence as a means of levying tax has been substantially diminished. This is most evident in the corporate world. With E-Commerce, there is no need or requirement to establish branches or agencies of businesses within any given jurisdiction or territorial boundary. Such technological advancement directly challenges the application of tax rules based on the established principles of physical presence, branch or agency.[10] Jose I Rojas reinforces this point by noting that "the moment a business connects its computers to the worldwide web, it is engaged in international commerce. This 'shrinking' of the world and the blurring of its borders creates a number of challenges to the application of our traditional view of jurisdiction"[11]

Business transactions conducted through the internet not only highlight the inadequacies of physical presence within a jurisdiction but it also creates undue pressure on the taxing officials to find innovative ways and means of exercising tax jurisdiction over persons using the internet to conduct business.[12] It is in the government's interest to attack this problem at its root. However, this problem is not lightly solved as the root had been allowed to be firmly planted without the benefit of establishing control over its application and operations. See the *Internet Taxation Freedom Act* (IFTA).[13] This Act

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10 E-Commerce has led to a fragmentation of commercial activity. The physical location of the supplier, service provider or buyer of goods or user of the services has become less important. *Canadian Tax Journal* vol. 47 1999. pg. 1412-1478

11 R. Allen Naude. Partner Practice Group. Internet-Commerce Aviation. International and domestic corporate/commercial E-Commerce. *Where we've been and where we are.*

12 E-tailers such as Amazon.com effect the greater part of their market research, advertising, marketing and sales through a web-site. The internet can be seen as an agent of disintermediation because it removes the necessity for certain intermediaries. Disintermediation means shifting part of their business operation from their physical intermediaries in source countries to their e-commerce base in the country of residence, thereby centralising their administrative, sales, marketing and after-sales operations.... This means a loss of source generated taxable profits and as long as international tax rules insist on physical presence requirement, their tax base will suffer erosion.

13 This Act imposes a three year moratorium on federal and state taxation of internet transaction because of the complicated issues surrounding e-commerce taxation.

bars states or political subdivisions from imposing any multiple or discriminatory taxes on transactions involving E-Commerce, including income and franchise taxes, property, sales and use taxes, as well as a seller's obligation to collect and remit such taxes.

E-Commerce as a business tool fosters competition, competition on the one hand between itself and traditional businesses and on the other with the government trying to maintain a stronghold over its authority to impose tax liabilities. This competition will force taxing officials to utilize the technology available to develop fiscal policies which is geared towards identifying, detecting and curtailing the manipulation of the tax system by e-traders.

Doing business via the Internet may be classified as 'cyberspace dealing' i.e. business being conducted anywhere and nowhere. This type of business practice gives E-commerce its unique characteristic (i.e. lack of physical presence, permanent establishment and its ability to avoid detection) which makes it difficult to be taxed under traditional concepts. E-Commerce lends itself to obscurity based on the following:

a). Computer to computer transaction which leaves no paper trail.

b). Anonymity of purchase and sales transactions. With anonymous transactions. There is a lack of information regarding the location of the seller and purchaser; sales tax laws are dependent on this information.

c). E-Commerce makes possible the electronic delivery of property and goods and services so there is no physical delivery by a common carrier (UPS, mail service). Also, the form of goods is converted from tangible to intangible which does not exist as an object. Many sales tax regimes exempt intangibles from taxation.

d). E-Commerce bundle taxable and non-taxable items e.g. taxable goods with tax exempt services such as software packages with e-mail technical support.[14]

The Lack of Paper Trail.

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[14] Taxation of E-Commerce. The challenge of e-commerce. _http://4-refund.com/genie32.html._

Unless a tangible product is delivered by a common carrier, it is impossible for a taxing jurisdiction to determine that an e-commerce transaction has taken place. Electronic money (a type of debit card) has the same anonymity as cash does on the 'black market'. The use of e-cash will further frustrate states and local jurisdiction in their effort to levy tax on e-commerce transaction. " Even without e-cash, e-commerce lends itself to concealment because of the relative lack of information on buyers and sellers and also because the purchase and sales transactions would enjoy the same secrecy as cash deals in the underground economy."[15] The fundamental characteristic which distinguished it from traditional activities is that it is concluded by electronic means. Thus the marketing of products or services is carried out through the enterprise's web-site. Payment is effected by credit card via secure payment systems and delivery is either by traditional means or the down loading of digitalized products

JURISDICTION BASED ON RESIDENCE.

Residence, ordinary residence and domicile are significant characteristics for the determination of an individual's liability to be taxed on his income whether arising within the jurisdiction or outside. The *Barbados Income Tax Act*[16] states that "a person is deemed to be a resident of Barbados with respect to any income year if he spent an aggregate of more than one hundred and eighty two (182) days of the income year in Barbados.

The common law position on the question of residence as is illustrated by case law is that it is a question of fact and degrees, ***IRC v Lysaght.***[17] In that case the respondent was born in England of Irish Parents. He worked in England until his retirement. He went to live in Ireland but visited England in relation to the work he continued to provide the company with which he was employed. His days spent in England did not amount to six months however, the court found that he was liable to be taxed.

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15 Ibid at FN 14.

16 S.85(5) *Barbados Income Tax Act*

17 [1928] A.C. 23

Levene v IRC[18] laid down the criteria for the determination of residence. This include the following:-

Physical presence

Past history

Present habits and mode of life

Frequency, regularity and duration of visits

Family and business ties

Jurisdiction with regard to individuals is not very critical in relation to e-commerce since individual purchases will not generate much revenue. This is based on the fact that individual purchases are usually done in small quantities. However, where residence is established, the difficulty as to who should be able to tax will become evident. Each taxing jurisdiction will want to jealously guard their revenue base. A government will resort to any means necessary to ensure that their tax collection is not undermined ***Levene v IRC.***

Jurisdiction with regard to individuals is not so much affected by E-Commerce as it is with Double Taxation Treaties e.g. Caricom Treaty of 1973. Where the tax is based on an individual's residence, he may use these treaties to his advantage to escape tax liabilities. However, E-Commerce plays its part in further eroding a country's tax base as it relates to individual jurisdiction. Income arising from this source is not viewed as a source from which tax liabilities become due. The more significant problem lies therefore in the determination of residence of a company. This is due largely to the fact that governments gain the bulk of their income from corporation tax. The residence of a company is determined along similar lines as that of the individual ***DeBeers Consolidated Mines Ltd v Howe***[19]

The Trinidad and Tobago Income Tax Act provides that "without prejudice to any other case in which a company is engaged in carrying on trade or business in Trinidad and Tobago, a company shall be deemed to be resident.[20]

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18 [1928]A.C. 217

19 [1906] A.C. 455

20 S.4 *Trinidad and Tobago Income Tax Act*

While the established criteria might have been adequate prior to the 1960's, that is not the case today. E-Commerce has tremendously affected the way businesses are conducted. "Residence taxation is challenged by the international mobility of businesses and the difficulty of enforcing national tax laws in a borderless world.[21] Businesses can easily be relocated to avoid residence taxation i.e. in the investor's home country. This is aided by the availability of technology "(through electronic records and encryption technology) which makes it difficult for governments to gather information on offshore activities and establish a reliable audit trail."[22]
It is argued that the residence of a corporation exist where the management and control of the corporation takes place ***DeBeers Consolidated Mines Ltd. V Howe.***[23] Usually the central management and control of a corporation takes place at its head office in the form of a permanent establishment.

THE CONCEPT OF PERMANENT ESTABLISHMENT

The concept of Permanent Establishment gives source states the authority to impose fiscal compliance burdens on a foreign company in that country. " This concept satisfies the requirement of certainty with relatively clear rules to determine in advance whether and in what way their activities abroad would be taxed by foreign tax authorities."[24] With the advent of the digital/technological age, Permanent Establishment as a tool for the imposition of tax jurisdiction has been gravely undermined. It is argued that "traditionally multinational corporations penetrate foreign markets by setting up physical intermediaries".[25] Physical intermediaries in this case, connote a fixed place of business under tax treaties, which imports source based taxation. E-tailers today, effect their market research, advertising, marketing and sales of their goods and services through a web-site which eliminates the need for intermediaries. The removal of such intermediaries from source states means that a Permanent Establishment is no longer required in taxing jurisdictions.

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21 Allen S. Bloom and Robert S. Grush, *International Tax Implication of E-Commerce. An outbound transaction.*

22 Ibid.

23 [1906] A.C. 455

24 The Challenge of E-Commerce. http://www.chetcuticauchi.com/jpc/research/oecd-e-commerce-permanent-establishment.htm

25 Ibid

It is argued that source states are justified to fear that their legal entitlement to tax foreign activities within their markets is steadily being eroded.[26] This is no surprise since E-commerce has rendered the base on which they are entitled to tax foreign corporations of no effect, i.e. the elimination of the Permanent Establishment. Additionally, the anonymity of Internet transactions renders taxing officials ability to trace them impractical.

What is Permanent Establishment for Tax Purposes?

A Permanent Establishment is found to exist if there is a fixed place of business through which the business of the enterprise is wholly or partly carried out.The principle that a country has the right to tax the business profits of a resident of another country "only if that person has a Permanent Establishment in that country is one of the primary legal principles of international tax law and is a vital provision in international tax treaties."[27] It must be noted however, that E-Commerce as a business tool has weakened this principle since it has virtually eliminated the need for a fixed place of business.Traditionally, the residence of a company has always depended on where its activities are carried out as exemplified in ***DeBeers.***[28] It was held in that case that the residence of a company is where it really keep house and does business. In ***Unit Construction Co. Ltd v Bullock***, a company made subvention payments to subsidiary companies situated in Kenya, the payment being deductible in computing its profits provided that the recipient companies were resident in the U.K. The memorandum and articles of Association of the recipient companies provided for management to be exercised in Kenya but in fact it was exercised from London. It was held that the companies were resident in England for tax purposes.

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26 Ibid.

27 Gloria J. Geddes. *Rethinking the concept of Permanent Establishment in the light of an E-Commerce driven International Corporation*

28 [1906] A.C. 455

The OECD Report[29] stated that a Permanent Establishment exists if there is a fixed place of business through which the business of the enterprise is wholly or partly carried out i.e.:-

1. There must be a place of business
2. The place of business must be fixed
3. The activities must be a core business activities

A Permanent Establishment encompasses the place of management and control of a company, a branch or office, a factory a workshop, an oil mine etc. All of the following represent a physical place and therefore imports a duty to be taxed.

In ***The Queen v Dudney***[30] a U.S. resident and other consultants were training employees of Pancanadian Petroleum Limited in a new technology. The training took place at the premises of Pancan. It was held that Mr. Dudney did not have a fixed place of business because the nature of the skill or service provided required very little in the way of a fixed place of business.

What is the Effect of E-Commerce on Permanent Establishment

E-Commerce facilitates the transaction of various business operations without the need or necessity for Permanent Establishment. A fundamental characteristic of E-Commerce is that it is conducted by electronic means i.e. the marketing of goods and services are carried out through the enterprise's web-site. Likewise, payment of such goods and services is concluded through the use of credit card via secure payment systems and the delivery of goods is either arranged by traditional means or allowing the downloading of digitalized products from the website onto the consumer's computer.It may be argued that the web-site has replaced Permanent Establishment as a medium through which business is conducted. As societies evolve, so too has the business climate to the extent that the need for central management and control as laid

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29 The Organisation for Economic Cooperation and Development. Committee on Fiscal Affairs, Electronic Commerce: A discussion paper on Taxation issues (Paris: OEDC, Sept. 17, 1998).

30 [1906] A.C.

down in ***DeBeers*** has become as elusive as the taxpayer himself.

E-Commerce is such a versatile business commodity that it allows for net meetings of management and subsidiaries from various locations i.e. "it allows for a point to point audio/visual conferencing and multi application sharing over the internet"[31] that the need for board room collaboration is now outdated.Net-meeting/teleconferencing is fast taking root in the modern business world as it is seen as a cost effective business tool which guarantees greater efficiency in the transaction of business operations. It is argued that employees can have access to a virtual conference room (not physical) for collaboration/communicating across different locations. "It allows companies to improve productivity and collaborate efforts without any geographical boundaries.Barbados Companies Act provides "…A director may if all the directors of the company consent, participate in a meeting of directors of the company or of a committee of the directors by means of such telephone or other communication facilities as permit all persons participating in the meeting to hear each other."[32]

Based on the foregoing, it is important to ponder, given the change of focus from the physical business office to Internet business transaction, whether the web-site can itself be deemed a Permanent Establishment. The presence of an enterprise in this sense, may be based wholly on the hosting of a web-site. The main enterprise no longer requires intermediaries in a foreign country to be able to conduct business there. The scope of market penetration via E-Commerce knows no limit. It also lends itself to anonymous business practices which seek to frustrate the established tax process. With E-Commerce Permanent Establishment is irrelevant since businesses are mobile and parties to e-transactions can be anywhere.It is the general consensus among OECD member countries that a web-site cannot by itself constitute a fixed place of business. It holds that "a web-site does not include any tangible property and therefore cannot constitute a place of business."[33] There is no facility such as premises or in certain circumstances machinery or equipment to qualify as an establishment as such.

The OECD Revised Commentary placed great emphasis on whether

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31 Genesys Conferencing Solutions. *http://www.imtc.org.*

32 S.79 *Barbados Companies Act, 1985.*

the activities carried on through a computer is proprietary or ancillary. This suggests that ancillary functions would not attribute permanence to the use of such machinery i.e. the web-site which provides a communication link (much like a telephone line) between customers and suppliers, advertising goods and services etc.

The web-site of an E-Commerce business is a combination of software and electronic data stored and operated by a server. It is an intangible entity which cannot be classified as a place of business.[34] The server on the other hand is the tangible aspect of the Internet process which sores the information and allows access to the Internet. The use of a serve however, does lend permanence to an e-business enterprise. E-Commerce traders may and often use Internet Service Providers (ISP's) who provide them with sufficient server space to transact their e-business. An ISP cannot in this sense, cannot be seen as an agent of the E-Commerce trader because it is not vested with the authority to transact business on behalf of the enterprise ***Humphrey v The Jolly Rogers Cruise.***[35] These ISP's are merely providing a service in an attempt to foster the growth of their own commercial enterprises.[36]

Given the ability of the computer equipment to relocate, it renders the risk of e-traders being identified and restricted to one jurisdiction for tax purposes impossible. It is argued that "the problems posed by E-Commerce is insurmountable as a server need not have any geographic connection either to

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34 Changes to The Commentary on Article 5. Electronic Commerce. An Internet web-site has no facility such as premises.

35 No. 61 of Barbados Supreme Court 1998.

36 Robert J. Spindler. *C.A International Foundation of E-Commerce Merchanting.* 39:1. 1999 Conference Report. Report of Proceedings of the 51st Tax Conference. Canadian Tax Foundation at the Montreal Convention Centre. Sept. 26-29, 1999. An ISP will not usually constitute a permanent establishment of its customers. A web-site is not a person and thus cannot be an agent for the purpose of the determination of Permanent Establishment.

the source country or to the residence country"[37]. According to Professor Hinnekens, "the fundamental distinctions and categories that previously guided traditional international tax law have been blurred by the relatively recent phenomenon"[38] By that this writer assumes that professor Hinnekens is making reference to degree with which e-Commerce has frustrated and undermined the established tax systems. It is true that the enforcement of traditional tax rules is made difficult in a cyberspace environment than it does is the brick and mortar business world.

Additionally, E-Commerce blurs the character of income and makes traditional territorial location meaningless. Difficulties in characterizing income derived from E-Commerce transactions include:-

1. Computer software payments
2. Digital products other than software
3. Services.

The most difficult is the characterization of software payment as a source of taxation. This is based on the nature of the transaction i.e. it fosters anonymity and non-detection. The challenge faced by tax officials represents an opportunity for businesses. In the interest of equity for both sides there must be a balancing exercise which seeks to address the erosion of the tax base.

SOURCE TAXATION.

The U.K Schedule D of the Income and Corporation Taxes Act imposes tax on income from any trade within the U.K. Section 5 of the Barbados Act states that"...assessable income of a person is his income from all source whether within or outside Barbados and without restricting the generality of the foregoing includes income from all:-

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37 The Challenge to E-Commerce. http://www.chetcuticauchi.com/jpc/research/oecd-e-commerce-permanent -establishment.htm. E-business may own or lease a server located any where in the world and conduct its business activities via this server in such a way as to ensure that their profits will be taxed by a low tax jurisdiction or not at all.

38 The Application of existing tax rules to e-commerce. OECD Ministerial Conference. Ottawa 1998.

1. Businesses
2. Property
3. Office
4. Employment

The source of income is becoming mobile in the E-Commerce environment because a transaction can take place anywhere in the world between two parties. To justify source taxation, there must be a distinct place of business i.e. premises or in certain circumstances machinery or equipment through which the business is carried out. If this is satisfied, the residence country will have the right to impose tax liabilities ***Shahmoon v M.N.R.***[39] In that case a U.S. resident had real estate holdings in Canada. Mr. Shahmoon would come to Canada and stay with his wife in an apartment maintained in Montreal for a total of one or two months per year. Mr. Shahmoon explained that he needed the apartment in order to live while in Montreal in accordance with his religious beliefs.... He used the facilities of a Canadian corporation to do what needed to be done in connection with his real estate holdings on his "sporadic" visits to Canada. It was held that Mr. Shahmoon did not have a permanent establishment in Canada for the purpose of carrying on his business.

In order to tax a foreign entity, the source country must establish that that foreign entity gains profit from commercial activities carried on within its borders through physical presence. This is a very difficult task since E-Commerce can disguise its business in such a way that no country can assume jurisdiction over its business activities.

E-Commerce transactions can involve a number of servers strategically placed in various countries or on one server situated anywhere in the world and accessible by consumers from any part of the world.

GENERAL

[39] Gloria J. Geddes. *Rethinking the Concept of Permanent Establishment in the Light of an E-Commerce Driven International Corporation.*

E-Commerce as a means of doing business undermined the traditional means by which tax officials derive revenue. E-Commerce facilitates business transactions without the having a fixed place of business, therefore, events which would normally give rise to tax liability in the traditional business world are likely to escape detection by fiscal authorities in the e-world. E-Commerce may be conducted through peer to peer networking where users trade digital products without resorting to any centraslised location. This undermines the OECD view that a web server may be held to be a permanent establishment for tax purposes. The ability of E-Commerce to manipulate how they conduct their business activities renders the task of identifying a permanent establishment virtually impossible. This may be one of the reasons why there is a lack of consensus among OECD member countries as to who should be taxed i.e. "whether the tax should be applied to the supplier or the end consumer."[40] Each state wants to retain its tax base and as a result will jealously guard their right to impose tax through territorial sovereignty or otherwise.

It is argued that the flexibility afforded by the Internet could have significant socio-economic and political implications if and when tax base migrate.[41] This argument is grounded in the fact that sustainable development and even maintenance of a country is based largely on its income gained from its revenue collection.

An attempt to reach a middle ground may be identified through double taxation treaties whereby countries agree on which country should tax which income generating activity. It must be noted that E-Commerce has set a new standard of doing business. Therefore, in order for taxing officials to maintain their revenue base, they need to keep abreast of the new developments and seek to establish policies that will ensure that they can tap into the source of E-Commerce business transactions.

E-Commerce is the reality with which Taxing officials are faxed and unless they find solutions to combat the challenges, their ability to levy taxes will become as illusory as cyberspace business dealings.

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40 Ibid.

41 *Euro-Market Designs Inc v Crote Barrel Ltd.* 96F Supp 2d. The Internet has transformed the world into a large market place.