

TAXATION OF ELECTRONIC COMMERCE IN DEVELOPING COUNTRIES: A CASE FOR SHIFTING OF FOCUS TO CONSUMPTION TAXES*

Abstract

The internet has transformed medium of business and consumers interactions. Parties to transactions are no longer confined to goods and services within their 'brick-and-mortar' but rather have access to goods and services beyond their physical reach. The problem however is that laws regulating commercial interactions in developing countries are still mostly conventional in their provisions and approach being tied to physical presence of the parties. As more business transactions are carried on through the internet and less business done using the traditional means, governments of developing countries suffer from a reduced tax base. The fact remains that most developing countries are importers of digital products from developed countries. This affords developed countries the opportunity to make lots of profits from the consumption of these products while escaping tax nets. This is made possible because the emergence of the internet has made it unnecessary for them to have permanent establishment in these developing countries. The focus of this paper is the assessment of the potential impact that e-commerce can have on the tax base of developing countries. The analysis is done against the background of the existing principles on international taxation. This paper concludes that it is essential to come up with an appropriate model that will suit the peculiar circumstances of most developing countries.

Keywords: *Taxation, E-commerce, Developing Countries, Consumption Taxes*

1. Introduction

Internet has evolved from a network of computers to a global social phenomenon.¹ Once a medium that offered access only to a few, the smartphone and mobile network revolution has thrown it open to a much wider and more varied audience in which process it has transformed itself from a place where people exchange information to where people conduct business as well and this, in turn, has thrown up new challenges to the legal, policy making and taxation stakeholders at a place that is ill-equipped to deal with.² E-commerce facilitates mobile, long distance, or anonymous transactions when the seller may be outside the territorial power of the taxing government or when the destination of the goods and services can be masked.³ Hence, there is a problem of identifying the seller or taxpayer, his place of business, verifying transactions and establishing a link between the taxpayer and the transactions for tax purposes.

E-commerce is multi-faceted kind of commerce that covers both tangible and intangible goods, has multi-jurisdictional nature and difficult to define tax jurisdiction due to the location of the server, citizenship, or residence of the person's registered domain name.⁴ Based on the extent to which the internet is utilised in the course of a transaction, e-commerce can be 'indirect e-commerce' and 'direct e-commerce'. The former involves transactions where the customers use the selection, ordering and payment process (electronic cash) of the retail stores or the mail order firms who use this medium for selling, marketing and advertising, but the delivery of the product and services takes place by traditional processes.⁵ However, the goods and services in digitised form⁶ acquired directly from the internet are referred to as 'direct e-commerce' which forms the crux of discussion in this paper.

The focus of this paper will be to assess the potential impact that electronic commerce can have on the tax base of developing countries. The analysis will be done against the background of the existing rules on international taxation. Even before the advent of electronic commerce, the existing principles on

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¹ C. Saxena Legal and Taxation Issues Concerning E-Commerce' (2015) 11 *The Indiana Journal of Law and Technology* p.87

² According to Bill Gates, Founder of Microsoft Corporation, 'If your business is not on the internet, then your will be out of business.' www.inscribd.com/19-bill-gates-quotes-about-business-real-world/. Last accessed 20/03/2017.

³ S. W. Salter 'E-commerce and International Taxation' (2002) 8 *New English Journal of International and Comparative Law* p.5

⁴ O. Abdulkarimli 'Taxation of E-Commerce' (2015) 1 *Baku State University Law Review* p.99

⁵ It should be noted that indirect e-commerce does not pose much of a challenge as delivery is carried out through physical means and tax can be easily imposed at the point of delivery.

⁶ J. Bick 'Implementing E-Commerce Tax Policy' (2000) 13 *Harvard Journal of Law and Technology* p.597

international taxation have been lopsided in favour of the developed countries.⁷ Therefore, in analyzing the potential impact of electronic commerce on the tax base of developing countries, it is essential to come up with an appropriate model that will suit the peculiar circumstances of most developing countries.⁸

The fact remains that most developing countries are importers of digital products from developed countries. This means that, businesses based in these developed countries, can derive lots of profits from consumers of digital products in developing countries but these foreign businesses can escape taxation because the emergence of the internet has made it unnecessary for them to have permanent establishments in these developing countries. In order to prevent a situation akin to that of the interstate taxation of electronic commerce within the United States⁹ from happening in developing countries, it is necessary for developing countries to come up with proactive and creative strategies to protect their tax base from further erosion. It is suggested here that the best way to do that is to shift the focus from taxation of incomes and profits derived from electronic commerce to consumption based taxes. Foreign businesses deriving profits from the sale of digital goods in developing countries should pay consumption taxes on their sales irrespective of whether or not they have a permanent establishment or a fixed base in the developing country. This is similar to the approach adopted by the European Union with the EU-VAT Directive.¹⁰

So as not to put the cart before the horse, it is imperative to give an appropriate description of what is meant by developing countries and e-commerce in this context. Developing Countries in this context refer to countries like Brazil, Russia, India and China (BRIC Countries) and other countries in Asia and Latin-America where there is a reported growth in e-commerce. It will also cover certain countries in Africa like Nigeria and South Africa where there is an increased growth in e-commerce. The United Nations Commission on International Trade Law (UNCITRAL) has defined e-commerce as ‘commercial activities conducted through an exchange of information generated, stored or communicated by electronic, optical or analogous means.’¹¹ More specifically, e-commerce has become an umbrella term for telecommunications activities conducted over open computer networks, such as the internet.¹² It must be noted that the 2016 China’s e-commerce became the largest in the world and is projected to a total of \$1.6 trillion in approximately 2 years.¹³ This is just an indication of the growth trajectory of electronic commerce in these developing countries.

This paper is discussed in six sections. After the introduction, this paper discusses the nature of e-commerce. Impact of e-commerce on the tax base of developing countries is interrogated in section three while the focus

⁷ibid

⁸ Chang Hee Lee notes that, ‘because the issue involves the state-of-the-art technological innovation, suggestions for changing the international tax order have largely been proffered by the advanced countries. In essence these countries argue for *lassiez-faire* – that the existing norms, designed in the pre-digital era, should remain intact to the broadest extent possible. See, Chang Hee Lee, ‘Impact of E-Commerce on Allocation of Tax Revenue between Developed and Developing Countries’, (2004)

(4)(1) *Journal of Korean Law* 19 at 21.

⁹ The position as to the ability of states in the United States to impose tax on e-commerce transactions is cumbersome and uncertain. Whereas states can impose tax on residents’ purchases from out-of-state or remote vendors, they cannot impose an obligation on those vendors to collect and remit such tax unless they can establish the vendor has a substantial presence or nexus in the state. See B.T. Ward & J.C. Sipior ‘To Tax Or Not To Tax E-Commerce: A United States Perspective.’ (2004) (5) (3) *Journal of Electronic Commerce Research* p.180; see also R. Jones and S. Basu ‘Taxation of Electronic Commerce: A Developing Problem’ (2002) (16) (1) *International Review of Law Computers & Technology* p.35; Swartz R.J. ‘The Imposition of Sales and Use Taxes on E-Commerce: A Taxing Dilemma for States and Remote Sellers’ (2003) 2 *Journal of High Technology Law* p.143.

¹⁰ See generally <http://www.ibfd.org/IBFD-Products/European-VAT-Directives>. Last accessed 20/03/2017

¹¹ See R. Hill and I. Walden, ‘The Draft UNCITRAL Mode Law for E-Commerce: Issues and Solutions’ (13) (3) *Computer Law* 18, 18 March, 1996 Last accessed 3rd March, 2017.

¹² See OECD, OECD Policy Brief No.1=1997 http://www.oecd.org/publications/Pol_brief/9701-pol.htm (last accessed March, 2017)

¹³ Note also over 40 per cent of the total global e-commerce spend came from China in 2015. <http://pfsweb.com/blog/2016-china-ecommerce-market/>; iresearchchina.com/content/details7_22434.html (last accessed march, 2017)

of section four is on imperative for designing a new model for taxation of e-commerce. Section five examines the need for a paradigm shift to consumption tax while section six is the conclusion.

2. Nature of E-Commerce

E-commerce, the act of facilitating business through the internet, sprung up only a few decades ago but has since assumed monumental proportions on a global scale.¹⁴ The number of internet users around the world has been steadily growing and this has provided the impetus and the opportunities for global commerce. Internet and e-commerce has grown to become an integral part of development process and has been predicted to be a new driver of economic growth for developing countries.¹⁵

Adel defines e-commerce as the electronic process by which individuals or organisations make a transaction, such as buy, sell, transfer, or exchange products, services and/or information.¹⁶ E-commerce is not limited to buying and selling over the internet but it is also concerned with transferring or exchanging products, services or information over computer networks. It includes activities such servicing customers online, collaborating with business partners and exchanging business documents within an organisation over the internet.¹⁷ An e-commerce transaction can be between enterprises, households, individuals, governments, and other public or private organisations.¹⁸ In terms of benefit, e-commerce allows businesses to reach global markets, despite geographical distance and time difference. It effectively and successfully erases the necessity of huge investments or outlays on physical infrastructure to develop a global presence, which has led to a revolution in the way business is conducted around the world.¹⁹

3. The Impact of E-Commerce on the Tax Base of Developing Countries

The growth of e-commerce is fast reducing the ability of federal, state and local governments to raise revenue from traditional sources in traditional ways.²⁰ E-commerce leads to gradual elimination of intermediaries, such as wholesaler or local retailers, who have been critical for identifying taxpayers, especially private consumers.²¹ The kernel of the issues to be addressed in this section has been succinctly summed up by Chang Hee Lee thus:²²

1. Digital technology completely destroys the economic and legal basis for the existing rules of international taxation, implying the necessity of a complete overhaul;
2. Extending the existing rules into the digital era, as suggested by developed countries (led by the OECD), will increase the revenue share of developed countries to the detriment of developing countries; and
3. Despite this foreseeable outcome, developing countries do not have much choice but to suffer.

However, while the first two propositions are invariably correct, it is difficult to agree with the third proposition. It is believed that developing countries have a choice as to what options they can explore in order to secure their tax bases from being eroded by electronic commerce. The Organisation for Economic Cooperation and Development (OECD), a group to which the industrialised countries belong and that develops economic policy information and studies, has been active in studying the impact of e-commerce on international taxation of income and consumption.²³ Particularly, there was an examination of the Ottawa

¹⁴ E-Commerce: The Answer to Poverty Eradication in Developing Countries? The Yale Tribune published in December, 2017. <http://www.campus.press.yale.edu/tribune/e-commerce-the-answer-to-poverty-eradication-in-developing-countries>. Last accessed 20/01/2018.

¹⁵ E. I. Japhet. and A. T. Usman 'Barriers to E-Commerce in Developing Countries' (2010) 3 *Information, Society and Justice Journal* p.3

¹⁶ A.A. Adel. 'E-Commerce in Developing Countries and How to Develop the during the Introduction of Modern Systems.' (2015) 65 *Procedia Computer Sciences* p.479

¹⁷ Ibid

¹⁸ E-Commerce in Developing Countries: Opportunities and Challenges for Small and Medium Sized Enterprises. http://www.wto.org/english/res_e/booksp_e/ecom_e.pdf. Last accessed 20/01/2018

¹⁹ Adel *supra* note 16

²⁰ J. Bick, *Supra* note 6.

²¹ R. Jones and S. Basu, 'Taxation of Electronic Commerce: A Developing Problem' (2002) 16 *International Review of Law Computers and Technology* p.35; See also N. Carey, 'Taxing E-Commerce: An Abundance of Constraints' (2014) 40 *Rutgers Computers and Tech Law Journal*. 156

²² Chang Hee Lee, *supra* note 8 at 21.

²³ S.W.Salter, *Supra* note 3

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Framework Conditions designed for the taxation of e-commerce by the OECD IN 1998. The Ottawa Framework Conditions made it clear that the existing rules on taxation should still be maintained with respect to the taxation of electronic commerce. According to the report:²⁴

The taxation principles which guide governments in relation to conventional commerce should also guide them in relation to electronic commerce. The CFA [i.e. Committee on Fiscal Affairs] believes that at this stage of development in the technological and commercial environment, existing taxation rules can implement these principles.

This approach does not preclude new administrative or legislative measures, or changes to existing measures, relating to electronic commerce, provided that those measures are intended to assist in the application of the existing taxation principles, and are not intended to impose a discriminatory tax treatment of electronic commerce transactions.

However, maintaining the existing rules as they stand will affect developing countries negatively while it will be to the overwhelming benefit of the developed countries. This is because the existing rules on international taxation is structured around the concept of permanent establishment which requires that before an entity can be subjected to taxation in a country it must have a fixed base in such a country.²⁵ But the advent of e-commerce has made it clear that it is possible to derive profits from a country without having any fixed base in that country. This is further complicated by the fact that most developing countries derive a substantial portion of their revenue from taxes on imported products and this source of revenue can shrink with the advent of e-commerce which allows the importation of digital goods and services which typically bypasses the usual means of importation for physical goods. Physical goods, unlike digital goods, can still be taxed at the point of importation.

This tension between developed countries, that are typically exporters of digital products, and developing countries that are importers of such products²⁶ cannot just be glossed over by insisting that the existing principles on taxation should also be applied to taxation of electronic commerce.²⁷ If taxes are paid to the developed countries where the digital products are produced it will be to the detriment of developing countries importing the products and from which the profits are being derived. The problem associated with what constitutes permanent establishment, which is usually resolved in favour of developed countries to the detriment of developing countries, can be exemplified with two Indian cases. In *eBay International A.G. v. ADIT*²⁸, the Mumbai Income Tax Appellate Tribunal (ITAT) held that revenue earned from operation of India-specific websites by a Swiss company for facilitating the purchase and sale of goods and services to users based in India was not taxable in India under the Indo-Swiss Double Taxation Avoidance Agreement (DTAA). Though the Swiss company had sister companies in India, the Indian entities could not be considered as 'independent agents' of the Swiss company so as to constitute a permanent establishment in India. Also in *ITO v. Right Florists P. Ltd*²⁹ the Kolkata ITAT held that the Google (Ireland) and Yahoo (USA) cannot be taxed in India in respect of sums received by them from an Indian florist for the purpose of online advertising. The ITAT found that Google and Yahoo did not have web servers in India and thus there was no permanent establishment unless the server on the websites are hosted and located in the same jurisdiction.

²⁴ See, OECD, 'Electronic Commerce: Taxation Framework Conditions', *A Report by the Committee on Fiscal Affairs*, 1998 at paragraph II.4&5, available at <http://www.oecd.org/dataoecd/46/3/1923256.pdf> (last accessed 3rd March 2017).

²⁵ See Article 5 of the OECD Model Tax Convention on Income and on Capital (Condensed Version, 2010).

²⁶ See Shyamal Mukherjee, 'Attribution of Profits To Permanent Establishments: A Developing Country's Perspective', (2002) *10 George Mason Law Review* 785.

²⁷ As Chang Hee Lee rightly argued, 'the existing norm of international taxation embodies express and implicit compromises among nations for allocating tax revenue from international trade and investment. The legal concepts carrying these compromises can ultimately be reduced to the economic nature of income and the territorial connection between a country and economic activities. These concepts cannot survive in a digital age. They only belong to a world that can be adequately modelled by traditional economic and legal concepts.' See Chang Hee Lee, *supra* note 8 at 25.

²⁸ TS- 734 – ITAT, 2012 Mum

²⁹ TS – 137 ITAT 2013- KOL

The position in Nigeria is not without some uncertainty also. Decisions of the Tax Appeal Tribunal in the cases of *GASPROM Oil & Gas Nig. Ltd v. Federal Inland Revenue Services*³⁰ and *Vodacom Business Nig. Ltd v. Federal Inland Revenue Service*³¹ are at variance. In the former case, the Appellant received consultancy and logistic services from a foreign company which never sent any employee or equipment to Nigeria. The TAT applying section 10 of the Value Added Tax Act held that it is absurd to hold a foreign company liable to tax in Nigeria solely on the ground that it does a business transaction with a Nigerian company notwithstanding that it is not carrying on any business in Nigeria.³² Although the TAT recognised the destination principle (as opposed to the origin principle) as basis for holding a foreign company liable in Nigeria the TAT held that the principle does not apply in the circumstances of the case. However in the latter case, the TAT came to a totally different decision even though the facts of the two cases are not dissimilar. In the latter case, the Appellant entered into a contract with a foreign company for the supply of bandwidth capacities for its use in Nigeria. The foreign company transmitted the bandwidth capacities through its satellite to the appellant who received same in Nigeria via its earth-based satellite. The TAT in its decision held that section 10 of the VAT Act is merely administrative in its provisions and not a precondition for the imposition VAT under section 2 of the same Act. It was further held that the destination principle is applicable to the case in order to avoid a classic case of double non-taxation.³³

It is therefore clear that the existing rules on taxation might not apply conveniently in this age of electronic commerce for several reasons. In the first place, under the existing rules, for the purposes of determining whether a company is subject to taxation for its business profits in a particular country, emphasis is placed on whether the company has a permanent establishment or a fixed base in the country.³⁴ Article 5 of the OECD Model Income Tax Convention defines permanent establishment as a fixed place of business through which the business of an enterprise is wholly or partially carried on. Under the same article, a permanent establishment may be created in a country by means of an agent, broker or general commission agent. Permanent establishment is a key tax concept because under most tax treaties, a business must be determined to have a permanent establishment in that country before the country can attempt to tax the profits of the business.³⁵

The concept of permanent establishment was invented before the emergence of the internet during the period when selling goods in a foreign country on a massive scale was not possible unless an employee or an intermediary was engaged in sales activity in the country and there was a business premise for such sales activity in the foreign country.³⁶ Once a foreign company has employees, intermediaries or a business premise, this was considered to be permanent establishment and the foreign company was thus liable to taxation on its business profits derived from that country.³⁷ It has however been suggested that a server could act as a permanent establishment.³⁸ The U.S. Department of Treasury has rejected this view stating that the server is like the owner of a warehouse, which is a passive activity.³⁹ Hence, passivity does not fulfil the

³⁰ (2015) 11 *All Nigerian Tax Cases* p.183

³¹ *TAT/LZ/VAT/016/2015*

³² Section 10(1) and (2) the Value Added Tax Act Cap V1 Laws of the Federation of Nigeria (LFN), 2004 provides that a non-resident company that carries on business in Nigeria shall register for the tax with the Board, using the address of the person with whom it has a subsisting contract, as its address for purposes of correspondence relating to the tax. And a non-resident company shall include the tax in its invoice and the person to whom the goods or services are supplied in Nigeria shall remit the tax in the currency of the transaction.

³³ Note that section 2 of the Value Added Tax Act stipulates that VAT shall be charged on all supply of goods and services while section 10(1) of the same Act provides that a non-resident company carrying on business in Nigeria shall register for the tax with the Board, using the address of the person with whom it has a subsisting contract, as its address for the purposes of correspondence relating to the tax.

³⁴ *Ibid.* at 35.

³⁵ C.W. Chan, 'Taxation of Global E-Commerce on the Internet : The Underlying Issues and Proposed Plans' (2000) 9 *Minnesota Journal of Global Trade* p.233

³⁶ *ibid.*

³⁷ *ibid.*

³⁸ B. Downey, 'E-Commerce : The Taxman's Nemesis' (2002) 2 *Asper Review International Business and Trade Law* p.53

³⁹ See Selected Tax Policy Implication of Global Electronic Commerce'' Nov. 1996- Department of the Treasury Office of Tax Policy. <http://www.ustreas.gov/taxpolicy/internet.html>> See also J.G.S. Yang, 'Emerging Issues in E-Commerce Taxation'' (2012 – 2013) 31 *Journal of State Taxation* p. 15

requirement of permanent establishment. This is in consonance with the OECD which indicates that a permanent establishment will not be created if the server merely performs preparatory or auxiliary activities which include provision of a communication link, advertising goods and services, etc.⁴⁰ Similarly, the OECD Model Tax Treaty exempts storage, display, delivery of goods and collection of information from its definition of permanent establishment. Even where a server is used for active transactions as opposed to passive transactions, Cockfield opines that the high mobility and flexibility of a server may make it unqualified to fit into the concept of permanent establishment.⁴¹ This is largely due to the fact that a server is merely a box and of greater importance is the server's software and programme which can be transferred instantaneously to a server in another jurisdiction and such programme can be maintained by employees or agents located outside of the source country.⁴²

Secondly, with regard to income generated from services, which is basically taxed in the country where the service is provided under the existing rules, the rationale for the existing rules also breaks down.⁴³ The rationale was that personal services required physical contact between the contractual parties.⁴⁴ But the advent of the internet makes this rationale to be illogical.⁴⁵ Hence, many companies have made a lot of money by posing as a simple middleman with little responsibility for the actions that take place on their e-platforms and this allows them to operate with skeleton staff with most of the heavy lifting being done by the software.⁴⁶ It is even now possible for a doctor to examine a patient in another continent and an architect can examine a building site without being physically present.⁴⁷

The approach adopted by the developed countries led by the OECD is ultimately serving their own interests as the major exporters of goods, services and capital.⁴⁸ An examination of the OECD Model Tax Convention (MTC) will reveal that no substantive amendment was made to the articles in the MTC to reflect the changes that result from electronic commerce, rather what was done was to introduce new commentaries to explain how the existing MTC can be applied to taxation of electronic commerce.⁴⁹ Chang Hee Lee further demonstrates how the approach of the developed countries will ensure that developing countries will lose substantial amounts of tax revenue. He gives the example of a supplier based in the United States who uses the internet to sell as many products to China as would have required a sales office within China in traditional commerce, yet China will be barred from taxing the supplier's income owing to lack of a permanent establishment.⁵⁰ This is because by virtue of the commentaries to the OECD MTC, an internet website does not in itself constitute tangible property and it does not have the location that can constitute a place of business⁵¹ and a website is also not a person like a dependent agent that can constitute a permanent establishment.⁵²

Special e-commerce problems arise with electronically-conveyed services and digitised products. These include whether a particular transaction involving an intangible should be classified as a service, licence of rights, or as a sale of goods.⁵³ Such transactions range from the provision of customised software to access

⁴⁰ A.J. Cockfield, 'Transforming the Internet into a Taxable Forum : A Case Study in E-Commerce Taxation' (2000-2001) 85 *Minnesota Law Review* p.1171

⁴¹ Ibid

⁴² Ibid See also A.J. Cockfield, 'Formulary Taxation Versus the Arm's Length Principle : The Battle Among Doubting Thomases, Purists and Pragmatists' (2004) 52 *Canadian Tax Journal* p.114

⁴³ Ibid.

⁴⁴ Ibid. at 35 – 36.

⁴⁵ Ibid.

⁴⁶ C. Saxena, *Supra note 1*

⁴⁷ Ibid.

⁴⁸ Ibid. at 37.

⁴⁹ Id. Commentaries in the OECD MTC dealing with electronic commerce can be found in the commentaries to articles 5 (dealing with permanent establishment) and 12 (dealing with royalties) and these were examined in great detail in chapter four.

⁵⁰ Chang Hee Lee, *supra* note 8 at 38.

⁵¹ OECD MTC Commentary on article 5 at paragraph 42.2.

⁵² OECD MTC Commentary on article 5 at paragraph 42.10.

⁵³ S.W. Salter, *Supra note 3*

to data, programs or games held in a server but displayed on the screen of the user in a different jurisdiction.⁵⁴ This usually leads to the problem of classification of the income generated from such transactions either as a business profit or royalty paid for the right in these intangible properties. The OECD principles for determining royalty income are also unhelpful to developing countries. Usually, even without a permanent establishment, a foreign company can still be taxed if it generates income which can be characterised as royalty income.⁵⁵ Royalties are collected for the use of rights such as copyrights. Most treaties on taxation between a developed and developing country usually provide that royalties should be taxed in the place where the royalty is sourced or the royalty-generating property is used and this makes it possible for the importing country to tax such royalty payments.⁵⁶

According to paragraph 17.2 of the commentaries to Article 12 of the OECD MTC, where the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or storage, or performance or display device, such use of copyright should be disregarded in the analysis of the character of the payment for purposes of applying the term royalty. This rule applies even where under the copyright law of a particular country transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer.⁵⁷ The implication of the above provision is that even where the transaction between the parties might entail the use of copyright which should ordinarily lead to royalty income; this might not necessarily be the case. This provision apparently blurs the distinction between royalty income and business profits as it applies to digital products.

One of the justifications given by the OECD for the retention of traditional principles for the taxation of electronic commerce is the concept of tax neutrality. According to the Ottawa Framework Conditions:

Taxation should seek to be neutral and equitable between forms of electronic commerce and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.⁵⁸

The argument based on the concept of tax neutrality is that it was necessary that the same rules should apply to both traditional (conventional) and electronic forms of commerce.⁵⁹ The principle of tax neutrality requires that any equitable tax system treat economically similar income equally.⁶⁰ For e-commerce to flourish, the principle of tax neutrality, as applied to e-commerce, would require that income earned through electronic means should be taxed similarly to income earned through more conventional channels of commerce.⁶¹ To do otherwise is to place e-commerce at a competitive disadvantage relative to other modes of commerce thereby defeating one of the purposes of equitable tax system.⁶² Chang Hee Lee however rightly argues that the reference to the concept of neutrality appears to be mere rhetoric or ideology.⁶³ According to him:⁶⁴

Neutrality means taxes should not affect economic choices. To the extent the total amount of tax burden remains unchanged, allocation of revenue among the nations does not affect business decisions. Compare three cases in which i) a Japanese supplier has a sales office in China and sells goods in China on a massive scale, ii) a Japanese supplier does not have a sales office in China and only sells a limited amount of goods sporadically, and iii) a Japanese supplier sells goods to China on a massive scale by e-commerce. None of these cases are identical. No mechanical concept of neutrality can be mandated subjecting the third scenario to the same tax burden as the second. The right issue is, which of the first

⁵⁴ Ibid

⁵⁵ Chang Hee Lee, *supra* note 8 at 39.

⁵⁶ Ibid

⁵⁷ OECD MTC Commentary on Article 12 at paragraph 17.2.

⁵⁸ See OECD, 'Electronic Commerce: Taxation Framework Conditions', *A Report by the Committee on Fiscal Affairs*, 1998 at paragraph IV.9 (i).

⁵⁹ Chang Hee Lee, *supra* note 8 at 42.

⁶⁰ See OECD, *Developing the Taxation Rules of the Road for Information Highway*. http://www.oecd.org/daf/fa/e_com/e_comm.HTM Z last accessed 3rd March, 2017.

⁶¹ C.W. Chan, *Supra* note 28

⁶² Ibid

⁶³ Chang Hee Lee *supra* note 8

⁶⁴ Ibid at 42 – 43.

two is closer to the third. The two relevant factors are the massive recurring sales compared to the existence of a sales office. To the eyes of many, the first factor must look more important than the second. Relying on tax neutrality is no more than well-packaged rhetoric to justify or insinuate an aura of moral claim to the revenue interests of the advanced countries.

4. Designing a New Model for the Taxation of E-Commerce

The development and growth of the internet brought with it several challenges for lawmakers and policymakers on several fronts. New crimes are being committed via the internet. The internet is also borderless and not confined to any single jurisdiction, and it is difficult to track and detect the activities of individuals online. In addition, the internet also provided a medium for breaching copyrights and also for the production of illegal copies of digital books, films and musical works. The problem of taxation of electronic commerce is just another one of the myriad of problems that we have to grapple with in this present information age.

The initial response of policymakers to the problems arising from the internet is usually to attempt to adjust and apply the existing laws to such problems. This is exactly what OECD has also tried to do with taxation of electronic commerce by suggesting that the traditional rules of taxation can still be applicable to electronic commerce. This approach however has been criticised. According to Johnson and Post, the regulation of cyberspace must be different from the regulation of real space because cyberspace does not have territorial boundaries, but exists simultaneously in multiple jurisdictions.⁶⁵ The usual approach of patching up existing laws to deal with new developments from the internet has to be changed and there is therefore a need to adopt new international principles that will take these new developments into proper consideration.⁶⁶ It is necessary to examine various suggestions that have made with respect to designing a new model for the taxation of electronic commerce.

It has been suggested that the most feasible solution for resolving this problem is by levying a withholding tax on electronic commerce transactions.⁶⁷ The argument is that using a withholding tax approach provides a more stable and appropriate basis for the source-based taxation of international electronic commerce transactions than the current international tax system.⁶⁸ This would be favourable to most developing countries whose residents purchase digital products from developed countries via the internet as it implies that once residents within a particular country make any online purchase they have an obligation to deduct and withhold taxes on their payments to the foreign supplier of digital goods or services online.

According to Avi-Yonah, the best way to tax electronic commerce is to introduce a withholding tax at the corporate rate for the source taxation of electronic commerce transactions.⁶⁹ Pinto suggests that a withholding tax should be applied by source countries (i.e. countries where online goods and services are purchased) on active income at a uniform rate to all international electronic commerce transactions generating withholding income, which would be refundable if the total gross sales of a business in a source country for the relevant period remain below a de-minimis threshold.⁷⁰ It must be noted that India's Authority for Advance Rulings has relied on withholding taxes in taxing electronic commerce under the United

⁶⁵ See D. R. Johnson & D. Post, 'Law and Borders: The Rise of Law in Cyberspace', (1996) 48 *Stanford Law Review* 1367.

⁶⁶ See American Bar Association, 'Report of the Task Force on International Tax Reform', (2006) 59 *The Tax Lawyer* 658.

⁶⁷ See R.S.Avi-Yonah., 'International Taxation of Electronic Commerce', (1997) 52 *Tax Law Review* 507; see also R. Doernberg, 'Electronic Commerce and International Tax Sharing', (1998) 16 *Tax Notes International* 1013; D. Pinto, 'The Need to Reconceptualise the Permanent Establishment Threshold', (2006) 60 *Bulletin for International Fiscal Documentation* 266 at 277; A.W. Oguttu & S. Tladi, 'The Challenges E-Commerce Poses to the Determination of a Taxable Presence: The Permanent Establishment Concept Analyzed from a South African Perspective', (2009) (4) (3) *Journal of International Commercial Law & Technology* 213.

⁶⁸ Oguttu & Tladi, *id* at 222.

⁶⁹ Avi-Yonah, *supra* note 61 at 507.

⁷⁰ Pinto, *supra* note 61 at 277.

States/India Treaty.⁷¹ The advantages of utilizing a withholding tax model for taxing electronic commerce are that it is operationally possible with the use of new technologies to assist with the collection, distribution and refund of the taxes withheld and such a model will also avoid issues regarding the characterisation of income that could become more complicated in the context of electronic commerce.⁷² There are however several shortcomings with the withholding tax model.

1. The withholding tax model has been criticised for not being tax neutral as it applies only to cross-border sales of goods and services that involve foreign sellers and not local sellers.⁷³
2. Withholding taxes based on gross receipts could be distorted where it is reasonably certain that the substantial part of the gross receipts consists of net income.⁷⁴
3. Taxpayers will incur the compliance costs associated with filing returns to obtain a refund of the amounts withheld, and tax authorities would incur administrative costs to ensure that the system is enforceable.⁷⁵
4. The anonymous nature of the internet can make it difficult to levy a withholding tax on electronic commerce. This is because the levying of withholding tax requires the identification of the resident taxpayer who must withhold the tax, from the purchase price paid to the non-resident and pay it over to the tax authorities.⁷⁶

There have also been other suggestions with respect to the appropriate model for the taxation of electronic commerce. The introduction of bit taxes⁷⁷ has been suggested. A 'bit tax', as it is suggested, should be levied on data that flows over the internet. A bit tax will however be an inequitable tax as it does not distinguish between the types of transactions involved. The implication of a bit tax is that there would be taxes on messages sent via email over the internet based on the amount of data sent in the email even if the email was not in furtherance of a commercial venture but was merely sent for private purposes. It has also been suggested that there could be a formulary apportionment of income between residence and source countries.⁷⁸ This means that invariably, developed countries (where most suppliers of digital products reside and are based) should be willing to share the tax revenue with the developing countries (where purchasers of digital products reside) based on a particular formula to be agreed upon by both countries.⁷⁹ The problem with formulary apportionment is that it is difficult to define the relevant factors that will be used to divide the taxes between countries.⁸⁰ It is therefore imperative to look at other possible means by which electronic commerce can be taxed in a manner that is favourable to both developed and developing countries. It is suggested here that the best approach is to shift the focus away from taxes on incomes and business profits to consumption taxes.

5. A Shift to Consumption Taxes

The ability to tax is fundamental to a country's sovereignty. The stronger a country's economy, the more revenue a government may collect through taxes; and, on the other hand, the weaker a country's economy, the more vital that revenue is to the country.⁸¹ Most developing countries rely heavily on consumption taxes. Data from developed and developing countries show that the ratio of income to consumption taxes in developed countries has consistently remained more than double the ratio in developing countries as

⁷¹ See, The Decision issued by the Indian's Authority for Advance Rulings (AAR), No. 30 of 1999 (238 ITR 296). See also Indian Ministry of Finance 'Report of the High Powered Committee on E-Commerce and Taxation' (2001) available at www.laws4india.com/indiantaxlaws/notification/ecomcontent.asp; Pandit, S., & Goradia, S., 'Indian AAR Issues Landmark Ruling on E-Commerce Taxation under US- India Tax treaty', (1999) *19 Tax Notes International* 11.

⁷² See, Pinto, *supra* note 61 at 227; Oguttu & Tladi, *supra* note 61 at 222.

⁷³ See, Pinto, *supra* note 61 at 278. It should be noted however that this may not be applicable in a country like Nigeria where the withholding tax mechanism does not discriminate between foreign and local sellers.

⁷⁴ See Oguttu & Tladi, *supra* note 61 at 222.

⁷⁵ See Pinto, *supra* note 61 at 277.

⁷⁶ See Oguttu & Tladi, *supra* note 61 at 222.

⁷⁷ See Pastukhov, 'International Taxation of Income Derived from Electronic Commerce: Current Problems and Possible Solutions', (2006) *12 B.U.J.Sci & Tech.L.* 310.

⁷⁸ Chang Hee Lee, *supra* note 8 at 47 - 50.

⁷⁹ *ibid*

⁸⁰ *ibid*

⁸¹ B. Downey, *supra* note 31

developed countries derive twice as much revenue from income tax than consumption tax.⁸² While it is true that most developing countries are channelling their efforts towards enhancing the growth of e-commerce within their borders, it must be noted that this could result in the loss of revenue to the state if appropriate mechanisms are not put in place early to address the issue of taxation of electronic commerce. In designing a legal framework for taxation of e-commerce, it is to be observed that the current framework at the international level is not favourable to developing countries and it might be difficult to negotiate for significant changes particularly at fora such as the OECD. This is due to the tension between capital exporting countries (developed countries) and capital importing countries (developing countries).⁸³ While the former prefers residence-based taxation of business profits, the latter prefers sourced-based taxation. The concept of permanent establishment which was introduced before the advent of e-commerce as a compromise between the two groups has however become unsatisfactory.⁸⁴ Profits can be derived from a country from e-commerce transactions without necessarily having a permanent establishment in that country.

It is therefore necessary to look at the ways in which developing countries can modify their existing tax laws to cover the taxation of e-commerce. It is argued here that the best way to achieve this is by shifting the focus from taxation of incomes and business profits to consumption taxes. Even the OECD agrees that consumption taxes in the context of cross-border transactions should be collected in the country of consumption. According to the Ottawa Framework Conditions, 'rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place...'⁸⁵ In other words, developing countries should adopt the same approach that the EU has embraced. This, it is thought, will avoid any unnecessary controversial debates at the international level unlike international taxation of business profits which is highly controversial.

The framework for the consumption tax should be designed in a way that it will only apply to foreign entities whose sales within the country to local residents exceed a particular amount.⁸⁶ This will reduce administrative and compliance costs as small entities that make no substantial revenue from the country will be exempted.⁸⁷

6. Conclusion

An attempt has been made in this paper to assess the potential impact that e-commerce has on tax base of most developing countries. The paper interrogates the nature of e-commerce and its potentials for stimulating economic growth in developing countries. It however warns that this anticipated economic growth may not be fully realised if these developing countries do not come up with efficient tax system that is capable of capturing all revenues from taxation of e-commerce transactions connected to them. Existing rules and models on taxation of e-commerce seem to be tilted in favour of developed countries and to the detriment of developing countries who are the major consumers of these products. While it is clear that the rules for apportioning revenue between developed and developing countries have to be redrawn with the advent of e-commerce, it is conceded that developed countries will be reluctant to agree to any adjustment that will be unfavourable to them. Thus, developing countries can adopt the less controversial option of extending their consumption taxes to cross-border e-commerce transactions in order to protect their tax base. Given the immense potential that e-commerce has to act as powerful tool in giving developing countries the chance to achieve economic equality with developed countries, it is necessary for developing countries to develop dedicated national strategies and policies for e-commerce development and taxation, customised to their resources and situation.⁸⁸

⁸² V. Tanzi and H.Zee. 'Tax Policy for Developing Countries' March 2001 International Monetary Fund, Economic Issue No.27 <http://www.imf.org/external/index/html> last accessed 3rd March, 2007

⁸³ A. J. Cockfield, 'The Rise of OECD as Informal 'World Tax Organization' Through National Responses to E-Commerce Tax Challenges', (2006) 9 *Yale J.L. & Tech.* 59 at 99.

⁸⁴ See Pastukhov, 'International Taxation of Income Derived from Electronic Commerce: Current Problems and Possible Solutions', (2006) 12 *B.U.J.Sci & Tech.L.* 310.

⁸⁵ See OECD, 'Electronic Commerce: Taxation Framework Conditions', *A Report by the Committee on Fiscal Affairs*, 1998 at paragraph V.11 (v).

⁸⁶ This is similar to the position in the Inland Revenue Authority of Singapore's *GST Guide on E-commerce*, paragraph 2.4 which requires only entities whose turnover exceeds S\$ 1 million to register for GST.

⁸⁷ See Neal Harold Luna, 'Implications of Singapore's Income and Consumption Tax Policies on International E-Commerce Transactions of Digitized Products', (2001) 10 *Pac.Rim L.&Pol'y* 717 at 739.

⁸⁸ See Adel, *supra* note 16